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HOUSING FINANCE REFORM: SHOULD THERE BE A GOVERNMENT GUARANTEE?

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

ON

EXAMINING A GOVERNMENT GUARANTEE IN HOUSING FINANCE REFORM

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C O N T E N T S

TUESDAY, SEPTEMBER 13, 2011

WITNESSES

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

HOUSING FINANCE REFORM: SHOULD THERE BE A GOVERNMENT GUARANTEE?

TUESDAY, SEPTEMBER 13, 2011

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:03 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Tim Johnson, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN TIM JOHNSON

Chairman JOHNSON. I will call this hearing to order. I would like to thank our witnesses for joining us today. This will be the tenth housing finance reform hearing held by the Committee, and the need for a Government guarantee has been an undercurrent in nearly all the topics we have covered so far.

Before the Great Depression, homeowners often had short-term or balloon mortgages they would roll over or renegotiate at the end of the term. But when there were runs on deposits and credit tightened, those homeowners had few opportunities for financing and were forced to sell their homes or enter foreclosure if they could not pay off the remainder of the underlying loan.

Since the Great Depression, our housing market has been built around a structure that involves the Government. Entities such as the GSEs, FHA, and Ginnie Mae, the TPE market, which Senator Reed explored in his Subcommittee, and the widely available 30-year fixed-rate prepayable mortgage all rely on a Government role to some extent. I firmly believe that we need to reform our housing finance system, but I am concerned about the unintended consequences for our housing market and economy that could result if a Government role is eliminated completely.

Returning to the housing system we had before the Great Depression would not be an optimal outcome. Rural States like South Dakota could suffer from a lack of credit and higher prices. With low population densities and housing turnover rates, access to a national mortgage market could be constrained depending on where investors were willing to put their money.

Without a Government guarantee, interest rates would likely increase across the country, but it is unclear by how much. When I have asked financial analysts and academics about this, the answers range from a quarter of a percent to 3 percent. At the high end, using today's rates, that would mean a monthly payment on a $200,000 mortgage would increase from about $975 to more than $1,350.

The 30-year fixed-rate mortgage would also likely take a different form and require substantial downpayments and higher interest rates, restricting the number of borrowers to a small number compared to today. If we use recently issued private label securities as a guide, the average downpayment was as high as 40 percent, according to testimony submitted for one of our previous hearings.

Since there has been a Government role in the mortgage market for close to 80 years, completely eliminating a Government guarantee would result in significant changes to the current market.

We have four witnesses who have written extensively on this topic, and I expect that they will help us navigate their arguments for and against a Government guarantee as well as the benefits and risks of a guarantee in good and bad economic times.

While there is not a single-bullet answer to some of our housing problems, this discussion will help us better understand how individual families and communities might be impacted.

With that, I will turn to Senator Shelby.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Mr. Chairman.

Mr. Chairman, thank you for calling this hearing. Today's hearing I believe will examine what is probably the most important question for housing finance reform. Can our mortgage market operate efficiently without a Government guarantee? How the Committee answers this question will, I think, dictate how we approach housing finance reform legislation.

If the Committee decides that the housing market needs a Government guarantee, then it is likely that housing finance reform will be largely a debate over how to structure the guarantee. Reform will be easier but also less significant because we will essentially be preserving the status quo.

However, if the Committee decides that the housing market can and should function without a Government guarantee, reform will then focus on how to transition to a private market. In that case, housing finance reform will be a bold undertaking that will fundamentally reshape how this Nation finances home ownership.

While some say there is no need for bold reform, I believe that all options should and must be on the table. Misguided housing policies pursued by the Federal Government and implemented by the GSEs played a significant role in causing the financial crisis. Therefore, the Committee I believe should determine whether other models of housing finance are more efficient, more sustainability, and less likely to impose losses on taxpayers than the current system.

It is my hope that today's hearing will help the Committee begin to understand clearly the real benefit and cost of providing a Federal guarantee in housing finance. Regrettably, explicit and implicit Federal guarantees were often viewed as ways to subsidize home ownership without incurring a cost to the taxpayer. The implicit, so-called cost-free guarantee of Fannie Mae and Freddie Mac has already soaked the American taxpayer for over $170 billion, and it is climbing. The Federal Housing Finance Administration estimates that the total cost could more than double even over the next 2 years.

It is clear that the old way of doing things failed on a massive scale. Failed. The question now is whether we have learned anything from that experience. I look forward to the hearing.

Chairman JOHNSON. Before we begin, I would like to briefly introduce the witnesses that are here with us today.

Dr. Richard Green is the director and chair of the USC Lusk Center for Real Estate at the University of Southern California.

The Honorable Peter J. Wallison is the Arthur F. Burns Fellow in Financial Policy Studies at the American Enterprise Institute. Mr. Wallison is also the former General Counsel for the U.S. Treasury Department.

Dr. Dwight Jaffee is the Willis Booth Professor of Banking Finance and Real Estate at the University of California, Berkeley.

And, finally, I would like to welcome Professor Adam Levitin, a professor of law at the Georgetown University Law Center.

Thank you all for being here with us today. I will remind you to keep your statements to 5 minutes. Your entire written testimony will be entered into the record.

Dr. Green, please proceed.

STATEMENT OF RICHARD K. GREEN, DIRECTOR AND CHAIR, USC LUSK CENTER FOR REAL ESTATE, UNIVERSITY OF SOUTHERN CALIFORNIA

Mr. GREEN. Thank you, Chairman Johnson and Senator Shelby, for allowing me to be part of this distinguished panel today. My name is Richard Green, and I am director of the Lusk Center for Real Estate at USC.

As you know, I have been asked to discuss whether the U.S. mortgage market requires a Federal guarantee in order to best serve consumers, investors, and markets. My answer to that is yes. I will divide my remarks into four areas:

First, I will argue that the United States has a history of providing guarantees, either implicit or explicit, regardless of its professed position on the matter. This phenomenon goes back to the origins of the republic. It is in the best interest of the country to acknowledge the existence of such guarantees and price them appropriately before, rather than after, they become necessary.

Second, I will argue that in times of economic stress, such as now, the absence of Government guarantees would lead to the absence of mortgages.

Third, I will argue that a purely private market would likely not provide a 30-year prepayable fixed-rate mortgage. I do not know that this is a particularly controversial statement. What is more controversial is whether such a mortgage is necessary, and I will argue that it is.

And, finally, I will argue that in the absence of Federal guarantees, the price and quantity of mortgages will vary across geography. In particular, rural areas will have less access to mortgage credit that urban areas, and central cities will have less access than suburbs.

Let me begin with the point that the U.S. has a long history of providing *ex post*—after the fact—guarantees as well as other guarantees.

One could reasonably argue that the United States was born from a bailout. One of the most famous compromises in U.S. history was the deal negotiated among Hamilton, Jefferson, and Madison for the new Federal Government of the United States to assume the Revolutionary War debts of the Continental Army and the individual States. This was followed by explicit guarantees for bonds that helped build the Transcontinental Railroad, and I could give other examples, but most recently, of course, we have many private institutions that have received Federal backing, including commercial banks who benefited from FDIC and TARP; the purely private investment banks who benefited from TARP; issuers of asset-backed securities who benefited from the Term Asset-Backed Securities Loan Facility, or TALF; and, of course, the Government-sponsored enterprises.

In light of the fact that the Government cannot credibly commit to no bailout policies, no matter what one thinks about the principle of Government guarantees, as a practical matter it makes sense to recognize them explicitly and to price them.

The second point is that in times of economic stress, debt markets do not operate in the absence of Government guarantees. Beginning with the Great Depression, the United States has faced at least five periods when private debt markets largely shut down. Liquidity was so absent that spreads were not only wide, but they were difficult to measure because of the absence of transactions. These included the Great Depression, the double-dip recession of 1979–81, the savings and loan crisis, the Long Term Capital Management crisis, and the Great Recession of 2008–09. Again, in each of these instances, it was Government coming in with a guarantee program of some form or another that allowed some restoration of liquidity and debt markets. Most recently, of course, we have had this with the fact that the Government-sponsored enterprises have become wards of the State and as such have been able to continue lending. It is frightening to think what might have happened to the housing market, already in very sick shape, had Government guarantees or had the GSEs not been there. As much as we might dislike them, one might argue that what they are doing currently is crowding out the private market. But if we look at parts of the private market where GSEs are not permitted to operate, we see an absence of lending in those markets, or at least it is very difficult to get a loan in those markets.

The third point is that in the absence of guarantees, I do think it unlikely that we would see a 30-year fixed-rate mortgage. The reason this mortgage is important is because it allows households to hedge two things: it is allowed to hedge interest rate risk against a long-term assets—a house is a long-term asset—but also human capital risk. By being prepayable the U.S. mortgage allows people to move when they have job opportunities in one part of the country or another. This is a hedge that I do not think is sufficiently thought about and is particularly important.

And the final point is that I think in the absence of Government guarantees, you would see the private sector cherry-pick certain markets over others. The problem with rural markets and central city markets is they are thin markets. There are not a lot of transactions. And it makes it very difficult to judge valuations in these markets, which makes them relatively unattractive for lenders. As a consequence, what Government guarantees allow is for everybody to essentially pool insurance, and as such, for everybody to get access to mortgage credit.

Thank you.

Chairman JOHNSON. Thank you, Dr. Green.

Mr. Wallison, please proceed.

STATEMENT OF PETER J. WALLISON, ARTHUR F. BURNS FELLOW IN FINANCIAL POLICY STUDIES, AMERICAN ENTERPRISE INSTITUTE

Mr. WALLISON. Thank you, Mr. Chairman, Ranking Member Shelby, and Members of the Committee. The question is: Should there be a guarantee in our housing finance system? And my answer is no.

I want to start with the question of the debt. We are all very worried here in the United States, and certainly in Congress, about the size of our debt. The CBO estimates that debt at about $14.3 trillion now, to go to $23 trillion in 2021 under current policies. If we add to that the $7.5 trillion that is agency debt—that's mostly Fannie Mae and Freddie Mac—we are talking about a $30 trillion debt for the United States in 2021. And if we guarantee mortgages or mortgage-backed securities under some plans that have been proposed, we will simply be increasing the debt even more. So this is a serious problem for us, and we have to consider whether it makes any sense to add to the debt by guaranteeing mortgages.

The next thing I would like to talk about is how we protect the taxpayers. What we have found again and again is that every time the Government has some sort of guarantee program or some kind of program to stimulate housing through a guarantee, the taxpayers get it in the neck. The taxpayers ultimately have to pay for it because the Government has no way of pricing risk. And to the extent the Government did have a way of pricing risk, it is not able to do it because for political reasons. It is very difficult to impose these seemingly arbitrary costs on the various members of society. So what happens is that the politics prevents the Government from getting compensated for its risks, and as a result of that, whenever organizations like the S&Ls fail or when Fannie and Freddie—which were also running risks—fail, the taxpayers have to bail them out.

And, finally, I ought to add—and this is also quite important in terms of the cost of the Government—when the Government guarantees anything it creates competition for Treasury securities, and that competition causes higher interest rates for Treasury securities—again costing the taxpayers. So there is no good reason to provide a guarantee, if once again we are going to be burdening the taxpayers.

Actually, there was an interesting paper by some Federal Reserve scholars recently estimating that there was an interest rate increase of somewhere between 30 and 100 basis points in Treasury debt because of a Government guarantee elsewhere.

The final thing I would like to mention is preventing bubbles. One of the arguments for guarantees is to provide for a steady flow of funds to the housing market, and yet when we do that we are ignoring all kinds of other businesses—automobiles or consumer credit or whatever it is—and focusing on housing, and what we do there is we are taking away some of the risks in housing. That creates more speculation, overbuilding, overlending, and overborrowing. This creates bubbles, and when they collapse we have tremendous losses.

Now, what are the reasons then for guarantees? One of them is that institutional investors will not buy mortgage-backed securities without a guarantee. This is not true. There are $13 trillion in fixed-income investments made by institutional investors. They are looking for more fixed-income investments of various kinds, and, of course, they take credit risk to do this. They are now investing in bonds and often junk bonds. What they need is more diversification. They want to be able to invest in mortgages. But they are not going to invest in Government-guaranteed mortgages because the yields are not sufficiently high. We need a private system, with market-rate mortgage-backed securities to attract institutional investors.

Another point is that there will not be, we are told, a 30-year fixed-rate mortgage without a Government guarantee. That is also not true. If you go on to Google and you put in "jumbo 30-year fixed-rate mortgage," you find that there are many, many offers out there, and a jumbo mortgage is not in any way guaranteed by the Government. So you can get a fixed-rate 30-year mortgage if you want one. You have to pay for it, but people ought to pay for that. There is no good reason to subsidize that mortgage. If we wanted to subsidize a mortgage, it probably should be a 15-year mortgage, which would actually allow people to accumulate some equity in their homes.

Finally, I will make one further point, and that is that mortgage rates, we are told, will be lower if we have a guarantee, and of course they will be. That is because the taxpayers are taking the risk. If we price these things according to their full risk, then the Government's rate would be exactly the same as the private sector rate. But we are not doing that. Instead, we are forcing the taxpayers to pay for the risks that the Government is taking.

Thank you.

Chairman JOHNSON. Thank you, Mr. Wallison.

Dr. Jaffee, please proceed.

STATEMENT OF DWIGHT M. JAFFEE, BOOTH PROFESSOR OF BANKING, FINANCE, AND REAL ESTATE, UNIVERSITY OF CALIFORNIA

Mr. JAFFEE. Chairman Johnson, Ranking Member Shelby, and Members of the Committee, I welcome the opportunity to talk with you today about what is really the future form of the U.S. mortgage market.

My comments compare what I believe are the two current and primary options for replacing the GSEs: private markets versus Government guarantees.

My research leads me to strongly endorse the private market alternative. I recently carried out research that compared the mortgage and housing market performance of 15 Western European countries with that of the U.S. This comparison is relevant because these countries systematically have very little Government intervention in their housing and mortgage markets compared to the United States. Indeed, none of them have any entities that correspond in any way to our GSEs. Nevertheless, on all statistical measures that I could find, the housing and mortgage markets of Western Europe have outperformed those of the U.S. over the last 10 to 15 years. My written testimony has a detailed statistical table. Let me just point out the two key findings.

First, the home ownership rate in the United States at year-end 2009 was 67.2 percent, which is exactly the average of the 15 European countries. Indeed, seven of the European countries have higher home ownership rates than the United States, and I emphasize with very little Government intervention in those markets.

Second, the average interest rate on mortgages in those countries is actually lower, in some cases by significant amounts, than the United States rates. Quite remarkable. Without any subsidies.

It is important to understand the source of the superior performance in Europe, and I believe it is very simple. They have extremely safe mortgages. The default rates in Europe even today under, as we know, distressed conditions in those economies, the default rates are remarkably low, and, therefore, they do not have to have high premiums for default risk.

I believe if the United States switched to an essentially private market system, we would obtain exactly the same benefits, and I would emphasize that having safe mortgages would save us what otherwise I fear will be a future replay of high default rates, high loan modifications costs, and high foreclosure rates. And it is my opinion that the U.S. housing markets would be much better without such costs facing us again.

Let me now turn to the Government guarantee proposals, and I am skeptical of these for several reasons. First, it is commonly suggested that we currently have no private market activity and that the proponents of these proposals see no signs of recovery. To me this is Crowding Out 101. Of course, if there are highly subsidized Government programs offering the same service as the private sector, we will see no private sector activity. But this offers, in my opinion, no evidence that private markets would continue to fail if the Government programs were removed.

A second common argument for the Government guarantees—and we heard it from Professor Green—is the 30-year fixed-rate mortgage. I strongly disagree. The 30-year fixed-rate mortgage does not require Government guarantees or GSE activity in any shape or form. The key point is that the risk an investor faces in buying a 30-year fixed-rate mortgage is interest rate risk, and neither the GSEs nor any of the Government guarantee programs have any actions to mitigate that risk. That risk is there in the marketplace, end of story.

Second, if you actually think of credit risk, private market investors will think of a fixed-rate mortgage as safer than an adjustable-rate mortgage. That is why we created the fixed-rate mortgage back in the 1930s, because it is a safer instrument. So there, again, the private markets will function just fine with fixed-rate long-term mortgages. As Dr. Wallison said, the markets are alive and well both in Europe and in the United States where the private sector provides these mortgages.

But most importantly, in terms of criticizing the Government guarantee proposals, my fear is that any proposal that actually gets enacted will put the Government in a first loss position, and that inevitably the Government and taxpayers and the borrowers will once again face the high costs of mortgage defaults and cumbersome losses associated with them. It is unfortunate, but the common experience with Government guarantee programs is that the political process inevitably leads to low underwriting standards, low premiums, subsidized costs, which cause taxpayers and borrowers to put themselves actually in harm's way.

Examples of this would include, for example, as you would know, the National Flood Insurance Program where Congress has recently had to make an appropriation for that.

Let me just close by saying that I understand that we have a transition problem. How do we get to this nice private market from where we are? And the answer is: Reduce the conforming loan limits in a sequence of steps that will create an orderly transition. October 1st you have your first opportunity. The current temporary increase in the conforming loan limits are scheduled to step down by almost $100,000. I hope that happens. I believe it would be an excellent challenge to the private markets to carry on.

Chairman JOHNSON. Thank you, Dr. Jaffee.

Professor Levitin, please proceed.

STATEMENT OF ADAM J. LEVITIN, PROFESSOR OF LAW, GEORGETOWN UNIVERSITY LAW CENTER

Mr. LEVITIN. Mr. Chairman, Ranking Member Shelby, Members of the Committee, in the perfect world, there would be no Government guarantee of the housing finance system. It would be a totally private system. And I want to make clear, I do not disagree with Dr. Jaffee or Mr. Wallison on any of the problems of a guaranteed system. A guaranteed housing finance system has many concerns. But the truth is, there is no real alternative.

The fundamental problem with housing finance privatization proposals is they do not work. Fully private housing finance systems simply do not exist in the developed world. The choice in housing finance is not a choice between Government guarantee and no guarantee. That is a false dichotomy. The Government inevitably bears the risk of catastrophic failure in the housing finance system. There is not a housing finance system in the developed world that does not either contain an explicit guarantee, as in Canada, or an implicit guarantee, as in Germany and Denmark, which happen to be the only other two countries with widely available 30-year fixed-rate mortgages. The real choice is not between a guarantee and no guarantee, but instead between an implicit guarantee and an explicit guarantee.

Despite all our best intents and declarations, the reality is that if faced with the imminent collapse of the housing finance system, the U.S. Government will bail out the system. It is simply not credible that any Administration or Congress will permit the U.S. housing finance system to collapse.

Prior to 2008, remember, Fannie and Freddie's obligations were explicitly not guaranteed by the U.S. Government, and yet they were bailed out. We simply have no ways of tying our hands against bailouts, and indeed, we may not even want to. Put differently, there is no way to guarantee against a guarantee.

Once we accept that any housing finance system has a guarantee built into it, there should be little debate about whether the guarantee should be implicit or explicit. An implicit guarantee would result in a system that would guarantee moral hazard, as private parties would have all of the upside while the Government would bear the downside. An implicit guarantee means that if things get rough, the Government will bail out the system, but it will not have priced for it.

An explicit guarantee has its problems, to be sure, as you have heard. But an explicit guarantee can be priced and structured to mitigate the risk. We may not get it perfect, but we can at least try and mitigate the risk that it will be used. That is not possible with an implicit guarantee. There is simply no thing as a non-guaranteed housing finance market other than in ideological fantasies.

Moreover, attempting to privatize the U.S. housing finance system puts the entire economy at serious risk. Eliminate the Government guarantee risks the flight of over $6 trillion from the U.S. housing finance market, roughly half the dollars invested in U.S. mortgages. Such an occurrence would be catastrophic for the U.S. economy, as mortgages would become unavailable or unaffordable for even prime borrowers.

Let me explain why privatization would result in a massive flight of U.S. mortgage capital. Mortgage investment involves two distinct risks, credit risk and interest rate risk. Most mortgage investors assume only interest rate risk. They are not credit risk investors. Investors in GSE and Ginnie Mae securities and MBS assume only interest rate risk, not credit risk. And investors in the now-defunct private label securitization were functionally interest rate investors. Over 90 percent of private label mortgage-backed securities were rated AAA at issuance. So the investors who relied on these ratings understood the credit risk to be negligible.

What this means is that the overwhelming majority of investors in the U.S. secondary market are not credit risk investors. They are solely interest rate investors, and they are unlikely to suddenly transform now, if ever, into credit risk investors, but that is precisely what a privatized housing finance system lacking a guarantee would do. It would require all the investors to become credit risk investors.

To the extent that rate risk investors can be lured into assuming credit risk, it will entail much higher rates of return on the securities, which will mean much higher interest rates on mortgages. And even then, it is doubtful that there would be anywhere close to a sufficient volume of interest rate risk investors willing to assume U.S. mortgage credit risk. Theoretically, there could be as much as $6 trillion lost from the U.S. housing finance system. Following the siren song of privatization would put the entire U.S. economy in grave peril.

Now, it is true that the U.S. jumbo mortgage market operates without a Government guarantee, but the jumbo market is substantially smaller than the conventional conforming market and jumbo securitization rates are also much lower, which indicates that there is a limited supply of investment capital for credit risk, even on prime jumbo mortgages. Most of them are held on balance sheet by banks.

The jumbo market also benefits from the existence of a guaranteed mortgage market in several ways. It is not a fully private market. It picks up benefits from having the Government guaranteed market.

In short, the jumbo market does not provide evidence that there is sufficient private risk capital willing to take on credit risk on U.S. mortgages. The bottom line is that when we are considering a Government guarantee in the housing finance system, we need to accept that there really is no such thing as a nonguaranteed system. Every system that claims to be fully privatized has an implicit guarantee. We saw this in Germany and Denmark in 2008. Germany bailed out a number of its mortgage lending institutions that issued covered bonds. Denmark did the same thing. That means that even in those systems that were supposedly fully private, that are held up as paragons of private systems that produce 30-year fixed-rate mortgages, we actually had an implicit guarantee that became explicit.

We just have never seen a fully privatized housing finance system and I think that we would be gambling with the U.S. economy if we tried to embark on such an experiment.

Chairman JOHNSON. Thank you, Professor Levitin.

Doctor Green, what are the economic risks associated with the absence of a Government guarantee for local communities from both an urban and rural perspective, and how would private investors decide to allocate their funds across the wide variety of housing markets in the country?

Mr. GREEN. In my view, as I said in my testimony, the problem facing rural markets and central city markets is you do not see frequent transactions in these markets, and as a result of this, we have seen difficulty in these markets attracting capital in a wide range of areas. So, for example, it is very difficult for central cities to attract grocery stores, even though we see a high density of income in these places that could support the grocery stores. So it ranges from the commercial market to the residential market.

And the problem is, when you are making a loan, you need to make a judgment about collateral, and the judgment about collateral comes from comparables, being able to see large numbers of sales. In suburban neighborhoods where you have homogeneity, where you have a large number of sales, it is pretty straightforward to determine what a house is worth and, as a result of that, to be comfortable with collateral when you are making a loan.

In rural areas and in central cities where the transactions are rarer and where there is also more heterogeneity, so it is hard to know whether one farm town is really the same as another farm town or not, making judgments about valuations is very difficult, and this judgment about valuation makes people less prone to want to invest in a place. They consider it an informational risk. And so if there is capital that flows to these places at all, it is in less favorable terms than it is in places where there is more homogeneity.

And so in the absence of a Government which sort of puts a backstop on losses that one might find in these rural communities and these central cities in the event of catastrophic events, I think you would see substantial differences in how these places are treated.

Chairman JOHNSON. Professor Levitin, both FHA and the GSEs lost market share to private market products during the housing boom. Why did the increase in private market participation not create a more stable market instead of the breakdown we experienced?

Mr. LEVITIN. The problem with the growth of the private label securitization market in the 2000s was that it was essentially an unregulated market. There were no marketwide standards that applied on mortgage origination or securitization, and what happened then was essentially a race to the bottom, where private label securitizers competed to get market share based on having ever looser lending standards, and the GSEs found themselves in a losing market share and their private shareholders were not real pleased to see that and pushed the GSEs to try and compete more vigorously through laxer lending standards and the result was we got in a race to the bottom and we are all paying the price for that.

Chairman JOHNSON. Dr. Jaffee, in the late months of 2008, the U.S. housing market was on the brink of collapse. Looking back, what would the housing crisis of 2008 have looked like if the Government had not taken over Fannie Mae and Freddie Mac?

Mr. JAFFEE. I believe that by that time, there was probably no option about saving Fannie Mae and Freddie Mac. I had written as early as 2003 actually predicting exactly what would happen, which was to say that the institutions, if nothing else, were going to end with a liquidity crisis. They had unbalanced interest rate risk. They had a huge maturity imbalance in which a third of their liabilities came due every year, even though they had very long-term assets, and it was only going to require one morning in the financial markets in which the current holders of Fannie Mae and Freddie Mac debt said, we do not want to buy it any more, we do not want to roll it over, and they would be, in effect, in a liquidity crisis and have to be bailed out. So by that point, I think there was no way around it.

Chairman JOHNSON. Mr. Wallison, your colleague Alex Pollock called for countercyclical measures to help prevent or at least protect against housing bubbles. Do you agree with his suggestion, and would the private market adopt these standards on its own?

Mr. WALLISON. Yes, I agree generally with the idea that we ought to have some sort of countercyclical process for preventing the decline in mortgage standards. However, the important thing to keep in mind is that if we have a Government guarantee, we are assuring that there will be a decline in mortgage quality standards because investors will no longer be interested in whether the mortgages that are being guaranteed are of good quality or not. That creates the race to the bottom that Professor Levitin talked about. And we exacerbate that because we increase the likelihood that weak mortgages will be developed by having such programs as affordable housing requirements for Fannie Mae and Freddie Mac, which caused them to buy very weak mortgages. That was one of the causes—probably the principal cause—of the financial crisis.

Chairman JOHNSON. Professor Levitin, without a guarantee, could the private market pick up the remaining market volume? If not, what would happen to the availability of mortgage credit?

Mr. LEVITIN. Without the guarantee, the private market simply would not pick up the volume of mortgage financing needed to sustain the U.S. housing finance market, and the result would be that a lot of people would be simply unable to get mortgages, or if they were able to get a mortgage, it would be at an extremely high interest rate. So we would really be gambling—if we tried to privatize the system, we would really be gambling with the entire housing finance system and taking on a risk that we would end up in a crisis that looks actually much worse than 2008.

I think it is important, though, that I say a word about something that Mr. Wallison just said. Mr. Wallison just tried to blame the Government's affordable housing programs for the financial crisis in 2008. I know that is the position he adopted in his FCIC dissent. I think it is important to state for the record that it is a position that has been thoroughly, thoroughly debunked and challenged by many other sources, and if you just want to see an example of a real estate market that tanked with no Federal involvement whatsoever, look at the commercial real estate market.

The commercial real estate market had a bubble that tracked the residential market almost to a T. The Federal Government is not guaranteeing anything in the commercial real estate market. The Federal Government does not have affordable commercial real estate goals or any regulation thereof. That market also tanked. Unless Mr. Wallison can explain what happened in the commercial market, it is kind of hard to place the blame on the Government's affordable housing programs for what happened in the residential market.

Chairman JOHNSON. Mr. Wallison, do you have a response?

Mr. WALLISON. Of course.

[Laughter.]

Mr. WALLISON. That followed what happened in the residential market. The residential market collapsed because of the affordable housing requirements. Quite apart from being debunked, as Dr. Levitin indicated, the data produced in my dissent from the FCIC report showed that the Government bought, through Fannie Mae and Freddie Mac and through other Government programs, two-thirds of all the weak mortgages that were outstanding. Some of the arguments that have been made are that, well, Fannie Mae's mortgages, Freddie Mac's mortgages, were better quality than other mortgages. Yes, that is true, but Fannie Mae and Freddie Mac are insolvent. In other words, they bought terrible mortgages; they had the power to acquire good mortgages and they did not do it. They began this process in 1992 when the affordable housing requirements were first imposed. The numbers are very clear, if anyone were to read my dissent from the report of the Financial Crisis Inquiry Commission, Mr. Chairman.

Chairman JOHNSON. Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

Dr. Jaffee, according to economic research, how much of the benefit generated by a Federal guarantee would actually go to consumers in the form of lower interest rates and how much of the benefit would go to the housing and banking industry? Have you done some research in that area?

Mr. JAFFEE. I have done some research——

Senator SHELBY. OK.

Mr. JAFFEE. ——and many of my academic colleagues have done even more——

Senator SHELBY. Yes, sir.

Mr. JAFFEE. ——and I think the numbers are—there is a broad consensus. Roughly speaking, the GSEs have probably been receiving a subsidy of approximately 50 basis points a year in terms of their ability to give guarantees that the markets basically assumed were Government guarantees as opposed to what they would have had to pay for, say, debt if they were private firms, 50 basis points.

The available evidence on the loans at the margin between conforming GSE available and above it, not GSE available, is about 25 basis points and it suggests that approximately half of the subsidy is going to the borrowers and half of the subsidy is going into the pockets of either the shareholders or the managers of the GSEs. And if you do the numbers, it comes out exactly right. That is why the GSEs over many years were able to report rates of return on equity at 30, 35 percent a year, which was double what any other bank in the world has been able to achieve.

Senator SHELBY. Professor Jaffee, would you just comment a little bit—you alluded to this—the idea of socializing the risk and privatizing the profits——

Mr. JAFFEE. Well, what——

Senator SHELBY. ——what we do when we guarantee something by the taxpayer, do we not?

Mr. JAFFEE. Well, for sure, we do. I would say the GSEs were the worst form of creating that because you created entities that had fiduciary responsibilities to their shareholders to maximize profits, and yet they quickly—in fact, it is interesting. The concept of an implicit guarantee was immediately adopted by the GSEs. If you go back and read the record and history, by 1969, 1 year after Fannie Mae became a GSE, and by 1971, 1 year after Freddie Mac became a GSE, they were telling the world, do not worry. We have an implicit guarantee. You can treat us as good as Government paper. And so they were adopting that immediately.

Once you have an entity that has profit incentives and a Government guarantee, the economics are very clear. You maximize your size and you maximize your risk bearing as much as you can get away with. Their whole history from 1968 to the collapse was a progression of greater and greater risk taking.

Senator SHELBY. Mr. Wallison, prominent bond trader Bill Gross recently stated, and I will quote him, "Without a Government guarantee, as a private investor, I would require borrowers to put at least 30 percent down and most first-time homebuyers cannot afford that." Of course, I understand his motive. You know, he is in the marketplace and he is a big bond holder. Some have pointed to statements like this and argued that most private investors will not buy mortgage-backed securities without a Government guarantee. In your testimony, you state that this is a myth disproved by the data. Would you explain?

Mr. WALLISON. Sure.

Senator SHELBY. Yes, sir.

Mr. WALLISON. The amount of fixed income investment by institutional investors is $13 trillion. Of that sum——

Senator SHELBY. Thirteen trillion——

Mr. WALLISON. Thirteen trillion dollars.

Senator SHELBY. That is not chump change, is it?

Mr. WALLISON. That is not chump change. That is money that is available to the mortgage market here in the United States.

Senator SHELBY. OK.

Mr. WALLISON. This purchase of GSE securities, however, amount to $1.8 trillion, a very small portion of the $13 trillion, indicating——

Senator SHELBY. Explain what you mean by G-series. That is Government——

Mr. WALLISON. GSE the Government——

Senator SHELBY. GSE.

Mr. WALLISON. That is Fannie Mae and Freddie Mac. Their debt, $1.8 trillion worth of their debt, was bought by these institutional investors, which indicates that these investors are not particularly interested in Government guaranteed debt. What they want is fixed-income securities that pay a market rate——

Senator SHELBY. Sure.

Mr. WALLISON. ——and that is not what they have been able to get as long as we have a Government-backed program. So the idea should be to make privately insured mortgage-backed securities now. That would make as much as $13 trillion available to our housing market.

Senator SHELBY. Dr. Jaffee, going back to you, if the Federal Government were to provide a broad explicit guarantee of mortgage-backed securities, then it would remove the need, some people argue, for investors to perform their own due diligence on the securities. Lack of due diligence, I think, is a problem here. Could any systemic risk to the U.S. economy arise if investors stopped doing their own due diligence on mortgage-backed securities? In other words, they say, well, the Government guarantees it. It is Fannie and Freddie. We are going to get paid regardless. Have you thought about that?

Mr. JAFFEE. Indeed, I have. Indeed, I find it remarkable, given the distress that we are still going through, having had an episode of terrible risk taking in the mortgage market, that we are contemplating Government guarantee programs which, in my opinion, will inevitably have the Government providing insurance with low downpayment mortgages, with low premiums, and that will actually induce the borrowers to once again put themselves into risky positions and inevitably, just as it does with floods, as it does with earthquakes, as it does with hurricanes, we are going to find the Government has to bail out these folks, and then Government then has to admit, we induced them to do it and now we have to bail them out.

A private market, in my opinion, will do just the opposite, and here I have to disagree with Professor Levitin, who suggested that investors in these private label securities were only concerned about the interest rate risk and somehow they did not worry about the credit risk. Absolutely not true. The structured finance format that underlies all private label securitization has an equity tranche. It has a mezzanine tranche. It has a B-level tranche, all of which are the investors who have to put their money in the first loss position.

In fact, it is quite remarkable. We never hear about those guys. They did not get bailed out. They all took their losses. These were hedge funds, they were mutual funds, they were pension funds, and they took their losses and that is where the equity losses were incurred.

In a new system, those investors, just as we see in Europe, those investors are going to say, I am willing to take private market risks, but I want safe mortgages, and I think that is the transformation that we are going to have and that is why we will not see another similar episode under a private system but we would under a Government system.

Senator SHELBY. Thank you.

Mr. Wallison.

Mr. WALLISON. Yes, I just want to add that of course these institutional investors will take credit risk. The idea that they will not take credit risk is mad.

Senator SHELBY. They are taking them every day.

Mr. WALLISON. Of course. Thirteen trillion dollars that is invested in bonds, including junk bonds—which is what they are buying now because they do not have other investments—is taking credit risk, and they would happily take credit risk on mortgages which are generally, if good quality, very safe investments.

Senator SHELBY. Can I ask you a question, then, Professor——

Mr. LEVITIN. Of course, Senator.

Senator SHELBY. I was getting to you. Thank you, though.

Mr. LEVITIN. Thank you.

Senator SHELBY. You are very patient. Bailouts after Dodd-Frank, and then you can get it. Professor Wallison, he was talking about the debt which is confronting all of us here in Congress right now and the American people. If we add the agency debt, if we add the continuing hemorrhaging of Fannie and Freddie, all this together, we are going to get up to $30 trillion worth of debt. Is the idea of a guarantee, which ultimately lays the groundwork for a bailout, you know, in other words, nothing is too big to fail, so to speak, is that smart in our economy today, in the world economy, with Europe reeling, we are reeling? Professor.

Mr. LEVITIN. Well, I think it is important to frame this the right way, Senator.

Senator SHELBY. Yes.

Mr. LEVITIN. The question is not whether we would put this all on the U.S. balance sheet now or never. It is simply a question of whether it goes on the balance sheet now or at the time of the next crisis.

Senator SHELBY. Wait a minute. It is either on the balance sheet or off the balance sheet, but the guarantee is there, you know, this whole idea—we sat here for years and talked about there is no real guarantee of Fannie and Freddie. We knew better than that. We knew better. So there is either implicit or explicit. Right now, with Fannie and Freddie sitting in the lap of the Government, of the taxpayers, it is very explicit, is it not?

Mr. LEVITIN. Oh, I think it is very explicit, but I do not think pretending that—if we did a privatization move and pretended that there was no guarantee, I am not sure that the market would be fooled.

Senator SHELBY. OK.

Mr. LEVITIN. I think that, you know, we look back at when we privatized Fannie Mae originally in 1968. That was to clear it off they Federal balance sheet in order to pay for the Great Society programs and the Vietnam war.

Senator SHELBY. Wait a minute. You said we privatized it. You mean we basically created a hybrid, did we not, a Government Sponsored Enterprise. That is not privatizing.

Mr. LEVITIN. Well, it is—there was no explicit guarantee. It was——

Senator SHELBY. But it was implicit.

Mr. LEVITIN. It was implicit, which is exactly what would happen if we tried to privatize it again. We cannot get rid of an implicit guarantee. There is no way to do that. The nature of the implicit guarantee is it exists whether——

Senator SHELBY. As long as we have a Government Sponsored Enterprise, I agree with you. We cannot get rid of it. But if we were to spin off, period, and have the private markets working, even step by step, we could get rid of it. But we would have to have, one, the political will here to get rid of it——

Mr. LEVITIN. It would take——

Senator SHELBY. ——and I am not sure that is here yet, but——

Mr. LEVITIN. I think it would take more political will than we have ever seen from the U.S. Government. I think Professor Green detailed it pretty well, the history of the U.S. Government engaging in bailouts of nonguaranteed entities, including most recently private institutions or banking systems.

Senator SHELBY. But I think you went back to the Hamilton era of where we—did not the Federal Government assume the States' debts incurred? That is a little different thing.

But you started to say something earlier. I want to be courteous to you, as long as the Chairman will indulge me.

Mr. LEVITIN. That is very kind, Senator. Thank you. I think there are two important points to make about diligence. First of all, yes, Professor Jaffee is right. There were some credit risk investors. But it is important that we understand the scale of that because this is really an issue of scale.

Of the private label mortgage-backed securities, something around 95 percent of them were rated AAA at issuance. That means only about 5 percent of them were being purchased by credit risk investors. Ninety-five percent of this market was not looking to take credit risk. And when you look at who those investors were, it is clear they have no ability to handle credit risk. Consider what——

Senator SHELBY. Like who, for instance?

Mr. LEVITIN. Chinese investment funds, for example. How is it that—so Federal Reserve Chairman Ben Bernanke actually has an article recently—he still publishes—pointing the extent of which the funding of the U.S. housing finance system was coming from foreign investors, particularly from East Asia. It is just not realistic to think that a Chinese investment fund——

Senator SHELBY. ——and why was it coming? Because they were led to believe that we would never let them fail, in other words, is that——

Mr. LEVITIN. That was part of it. They did not think there was going to be any credit risk, and had there been credit risk, they would not have invested because they have no way of doing diligence on U.S. mortgages in any meaningful capacity. They are at such an informational disadvantage that they simply would not invest in that. They are not looking for credit risk. They are looking—they can figure out what is going to happen on U.S. interest rates, they think, but they have no idea what is going on on the ground with U.S. mortgage lending and they make no pretense of it.

Senator SHELBY. Professor Green, maybe I can get to you on the next round. Thank you.

Chairman JOHNSON. Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman. My thanks to the panel for their testimony, which I have read.

Let me ask you, Professor Levitin, in the days before GSEs, loans were generally renewed every 3 to 5—or due every 3 to 5 years and had to be refinanced all the time because lenders were not willing to make 30-year commitments. So now we hear that once the Government gets out of the way, private capital will automatically enter the market and replace the Government's position.

What assurances are there of that, that it will occur in a timely fashion, considering that we have yet to see significant private capital participation in, for example, the jumbo mortgage market or significant private capital returning to the mobile home market? What if we eliminate, as some suggest, the GSEs and we turn out to be wrong about private capital coming back to fund 30-year loans?

Mr. LEVITIN. There is absolutely no reason to believe that private capital would immediately step up, even if it would eventually step up. And there is really not good reason to believe that it would eventually step up in sufficient volume. If we are wrong about this, we have a financial crisis on our hands that far exceeds that in 2008.

Senator MENENDEZ. And one of the challenges I see is what if we completely eliminate the GSEs, as some are proposing? By how much do you think the cost of a mortgage would go up for the average middle-class family trying to buy a fairly modest home?

Mr. LEVITIN. Actually, giving you a precise estimate is outside of my particular area of expertise, but I would expect—you heard a range of estimates. I have actually, I think, heard a higher estimate from Bill Gross, the head of PIMCO, which I think he said something around the range of 400 basis points. I do not want to quote him on that, though. But we would see that—we could potentially see a significant increase not just in interest rates but also in downpayment requirements. And you put those together, and we could see a large number of American families simply shut out of the mortgage market.

Senator MENENDEZ. And then——

Mr. LEVITIN. And I am sorry. I want to make one other point with that. If that happens, that causes a precipitous collapse in housing prices, which then triggers further defaults, and we can end up in something of a death spiral.

Senator MENENDEZ. And, of course, those costs would be significant over the life of a loan.

Dr. Green, do you have any views on this?

Mr. GREEN. Well, it is not so much the cost as the availability of the product per se. So, again, it is really hard because making an apples-to-apples comparison is very difficult.

Mr. Wallison discussed the fact that you can go on Google right now and get a jumbo loan, you will see a lot of people offering jumbo loans. But I am kind of wondering whether he has actually tried applying for one of them in the last 6 months.

I did a refinance on my house on a 30-year jumbo, and it was very striking to me because when my wife and I got our first mortgage when we had our jobs for a year and all we had in the bank was a downpayment and that was it, it took like 2 days to get approved. It took us 4 months to get approved on our jumbo non-cash-out refinance. And I do wonder about whether our housing market can actually transact if it takes 3 to 4 months in order for a loan to get approved.

So there is a lot of stickiness in the process as well. How that exactly translates into a price I am not exactly sure. But if you say 50 basis points plus it is going to take you another 2 to 3 months to get your mortgage, that is a very different kind of calculation than just saying 30 to 40 basis points.

Senator MENENDEZ. Currently, small lenders such as community banks or mortgage brokers are able to participate in the mortgage market by selling loans to Fannie and Freddie without having to go through one of the big banks to accumulate enough loans to create a securitization pool. What would the various reform proposals do to the ability of small lenders such as community banks or mortgage brokers to compete in the mortgage market? Would this be a concentration of the market in the hands of a few players? Professor?

Mr. LEVITIN. I think we would like—if we took the privatization, which I want to emphasize again is really an implicit guarantee route, I think that we would see concentration being the order of the day. And the reason I believe that is if you look at what happened in the private label securitization market, it did not have a long life during which it was, you know, a sizable market. But as that market grew in the 2000s, the move that happened was investment banks started to create integrated origination to distribution chains where they would purchase—they would have their own loan originators, and they would have their own securitization conduits. The move was to integration, and that integration move would really try and push out any other competitors on the origination front, your community banks, your credit unions, and I think that we would see them really losing business if we moved to a privatized or really implicitly guaranteed market.

Senator MENENDEZ. Thank you.

Mr. Chairman, I would ask unanimous consent that my statement be entered into the record at the beginning of the hearing.

> Thank you Mr. Chairman for scheduling this hearing whose topic in my view goes straight to the heart not only of Government support of the housing market, but also to the question of what our values and priorities are as a Nation. I look forward to getting America's housing finance system back on track, which is why I'm also looking forward to my Housing hearing tomorrow afternoon on New Ideas in Refinancing and Restructuring Mortgages. As families back in New Jersey, whether they own their homes or they are renting, are struggling through these tough times, we need to make sure that they have access to 30-year fixed-rate mortgages. I don't think we should give up on the American Dream of home ownership because of the current housing market setbacks. As we consider various options for ensuring that taxpayers are protected, I hope we recognize that with the private securitization markets still badly broken, Government currently needs to play a role in ensuring that these affordable housing objectives are still met so that America's well-qualified middle class families can still get mortgages when it comes time to buy a home and raise their families. Given that the housing market has not done as well as expected, I think now would be the wrong time to withdraw that Government crutch that has been one of the only things holding up the housing market. That's why I believe allowing higher loan limits to expire would be a preventable mistake and why I hope this Committee will support the bipartisan Homeownership Affordability Act introduced by myself and Senator Johnny Isakson to maintain those limits temporarily. We extended them last year when the housing market was bad, and I don't see why we wouldn't extend them again given that the housing market has gotten worse since that time a year ago and 42 States would take a hit to their housing markets if we allow the limits to go down. So I look forward to addressing that, and I look forward to your testimony.

Chairman JOHNSON. Yes, it will.

Senator Corker.

Senator CORKER. Thank you, Mr. Chairman, and I thank each of you for your testimony. You know, a lot of people talk about gridlock here in Washington, rightfully so, and I was just thinking as I listened to the testimony of three professors that we are certainly creating another generation of gridlock among students in America. And in order to sort of bring maybe people together on a couple of issues, because we are probably going to have some housing legislation, I hope, during this Congress.

Would it make some sense, to sort of bring the two bookends together with the middle, to at least look—at the end of this month we have got the qualified—the mortgages, the ceiling dropping from 729 down about a hundred grand. Would it at least make some sense to allow that to go ahead and occur and see if we can backfill that with private demand instead of continuing the policy that we have right now? The two guys on the end. I know the guys in the middle say yes.

Mr. GREEN. So as a Californian I should not say this, but I think it absolutely would be a worthwhile experiment, and it would test whether Professor Jaffee or I is correct about this, but yeah. You know, I have no disagreement with the idea that if you are going to have a guarantee, that it should be limited to middle-class mortgages. I do not know exactly how to define that, median price of a house plus some small increment.

Senator CORKER. Professor Levitin.

Mr. LEVITIN. I do not disagree. I think that is actually a reasonable approach today, and let us see what happens if we do this as a small scale and do not take away the guarantee altogether but see what happens if we ratchet it down.

Now, I would emphasize, though, remember that the current level of the guarantee is much higher than it had been even a few years ago.

Senator CORKER. Right. I think there is probably going to be an attempt to try to not let that drop, and I just appreciate the fact that even though both of you have advocated for keeping GSEs in place and that type of thing, you would at least agree that dropping that down and seeing if we can backfill that with private sector demand makes some sense at this moment. It seems to me that what has happened is people reacting to some very draconian bills—maybe they have been put forth in the House—instead of saying, well, you know, probably where we are today, we are way too dependent on Government, and we ought to reach a place that at least is less dependent. I think people could agree on that. And maybe some steps to try to backfill would make some sense, which brings me to a second point.

A lot of people say the TBA market will not work without GSEs, but we have corn futures and oil futures and pork belly futures. I mean, is there any reason to believe that without a Government guarantee you could not still sell into the forward market as long as you had certain credit criteria?

Mr. LEVITIN. Well, you do not need the Government guarantee per se to have a TBA market. What you need is standardization. A Government guarantee standardizes credit risk. It is——

Senator CORKER. Well, but it does not have to be that way, and I think what we have seen actually, because the private investors have been on strike, is a movement toward some standardization. So if we had some standardization in the marketplace, we had some industry criteria that people adopted, you are seeing the TBA market could function easily.

Mr. LEVITIN. If everyone complied with that, and we have not seen that develop yet.

Senator CORKER. But that is something that, again, I think much of what we do here is to try to create the environment and let the private sector generate the risk—or take the risk. Do you agree with that, Dr. Green? These other guys I know pretty well, so I know what they are going to say.

Mr. GREEN. I think you would have to somehow come up with a mechanism where investors would have confidence that people really are meeting the standards, and in light of the way that we are finding out about how mortgages not only were underwritten but the way documentation has been maintained and so on, I think the market is a very, very long way from having that kind of confidence. The standards have to stick in order for that to work.

Senator CORKER. So if a Democrat and a Republican came forth with some legislation to step down over time the loan limits and to create a TBA market by actually creating some standards, some industry standards, our two bookends, for lack of a better word, would think that would be a methodical and thoughtful way to try to prime the market.

Mr. LEVITIN. I want to be clear in the way I am supporting this and the way I want to have some caveats with it. I think yes, as a general matter, that is a very reasonable approach. We would want to see exactly what would happen if private capital would step up. But I think it is also—the devil is often in the details.

Senator CORKER. Sure.

Mr. LEVITIN. And what the standards are is, I think, going to be rather tricky. It is one thing if Congress imposes standards. It is another thing to have industry develop standards. And one thing we saw in the private label securitization market was incredible heterogeneity. They did not come up with homogenized products because they did not want them, because if you can compare apples to apples, you get better competition, and that means smaller margins.

Senator CORKER. I appreciate it. I got the caveats, and I understand all of us keep those caveats.

Let me ask one last question. I know my time is short here. There is no question that we subsidize the housing industry. Does anybody disagree with that? I mean, with the home mortgage deduction and—so here is—I actually spent a lot of my life trying to help lower-income citizens own housing as a civic endeavor, not as a business. And it seems to me that what we have done with our housing policy is we subsidize housing so much that we actually drive the price of it up. So, you know, it seems to me that as a social policy in our country, we would rather people have lesser amounts of indebtedness than more amounts of indebtedness. But what we do with our housing policy by subsidizing housing the way we do, we drive the price up; we lower the cost of loans, but we drive the loan amount up. And it seems to me that unintentionally, you know, with good intentions, we have actually done some pretty perverse things in our society as it relates to housing, and that we would be so much better off to actually price the risk as it really is and to not do what we do in our country by driving up prices. I wonder if you all might just comment on that briefly. And, Peter, I know you want to say something.

Mr. WALLISON. I agree, of course. We do that. And, in fact, the 30-year fixed-rate mortgage is a perfect example of that. We subsidize that mortgage because we think it is a good idea. What it does is reduce the monthly payment. The reduction in the monthly payment allows people to buy a bigger and more expensive house. Eventually, they have less equity in their homes. It is not good policy. If a person wants to do it, that should be available. But the real cost of it should not be subsidized.

Senator CORKER. Does anybody disagree with the fact that that is exactly what we have done in our country? Nobody disagrees.

So, Mr. Chairman, I just think as we had one witness talk about the fact that those with good credit through the GSEs allow those people with bad credit to get loans at the same amount, I think that was a pretty interesting comment.

I think to have people of such huge philosophical differences to say what has just been said is something that we should address and realize that as a country we have done some really perverse things as it relates to housing policy and really caused people to have more indebtedness than they otherwise would have.

Chairman JOHNSON. Senator Merkley.

Senator MERKLEY. Thank you very much. I am fascinated by this conversation because you all study the housing market and mortgages day in and day out, but you reach such dramatically different conclusions.

Mr. Wallison, I think you stated several times that a guarantee induces a race to the bottom in terms of the quality of underwriting because investors no longer have a reason to be discriminating, if you will. Let me just test that against a couple items.

The first is there was huge private money that was put into private label securities and into subprime pools, and done so by private investors, and yet it was extremely risky, incredibly poorly underwritten. Doesn't this work against the argument that private investors are studying the quality of the mortgage investments and driving, if you will, the quality?

Mr. WALLISON. Much of that investment was, as we know, rated AAA, and as Professor Levitin suggested, that for those buyers may have given them the idea that they were not going to be taking major credit risk. The problem with a Government guarantee, as we all know, is it creates moral hazard, and that means that you do not really worry about whether the mortgage that you are buying or the mortgage-backed security that you are buying is going to fail. That is the real danger.

Now, what we know about what happened with the AAA securities, the private label securities, is that they were—when the bubble was growing—it was very easy for someone to look at those securities and say, "Gee, there are not many defaults going on here. These are not as risky as you would imagine subprime mortgages would be." And the reason for that, of course, is when a bubble is growing, housing prices are going up, and people who cannot afford to pay their mortgages can simply refinance or sell the house and not suffer any losses. So investors thought they were really getting a good deal here—high yields, AAA securities. That is the sort of thing that was created by the Government having come in in the first place and pumped a lot of money into this bubble.

Senator MERKLEY. Well, I think the first line of your answer was that the investors did not discriminate because they had a AAA rating. And indeed that points to a whole different issue and problem that none of you have raised up here on the panel, which is that even sophisticated investors used the rating system because they cannot get otherwise to the details. Unfortunately, our raters could not get to the details either, and there are these terrible stories of individual employees going to their bosses and saying, "I cannot get loan level details, and you are asking me to rate this security." And they are saying, "Well, too bad. This is what you have got, and this is how we make our money, and so rate it." And we have not really addressed that yet in terms of our efforts on housing policy.

I worry that we may be taking a few of the wrong lessons. My colleague has left—Senator Corker. He pointed out we did some terrible things. But I think the argument should not be about what we did from 2003 through 2008 in terms of the role of mortgages, but it should be about the model we had before 2003. In other words, before we allowed liar loans, teaser-rate exploding interest loans, prepayment penalties to lock people into this—all practices that we have now banned here, and it is good that we did ban them. They introduced a whole—talk about if you track the predatory practices and you track the influence on the bubble, that would have had a huge factor. But really what our argument is, we know those things were a mistake. What we should be looking at is that period from post-World War II up through 2003 and how the mortgage market worked then and keep the baby while we are throwing out the bath water, if you will.

And so in that sense, are we, in fact, pulling the right pieces of the debate in terms of trying to design the mortgage market of the future? Or are we misusing the period of 2003 when these predatory practices were allowed as really an argument against the previous period? Mr. Levitin.

Mr. LEVITIN. Sure. You have to ask what changed in 2003, what went wrong, and I think we can point at several things, but one of the factors that I think certainly deserves some attention is the erosion of consumer protection laws. Prior to the 2000s, we actually had a fairly robust web of consumer protection laws on the State level. You know, they were not standardized, they varied, their application varied, but they still existed. And that put some brakes on some of the more aggressive lending tactics.

One thing that happened was that we had really an aggressive campaign of Federal preemption by the Office of the Comptroller of the Currency and the Office of Thrift Supervision to preempt the State consumer protection laws without substituting any equivalent Federal protections. Preemption makes a lot of sense if you are going to have a national standard. But when you preempt without having any standard, then you just end up with a regulatory vacuum. That opened the door for really having the race to the bottom. As long as those standards were in place across the whole market, it limited the ability for the GSEs really to get in and ensure a rate war. And I think it is important that we think of the GSEs as insurance companies, and a common problem in insurance regulation is that you can get a rate war where insurers start competing for market share by charging ever lower premia relative to risk. And when that happens, it leaves undercapitalized insurers.

I just want to turn to one thing that Mr. Wallison said. He raised the moral hazard point, which exists in any insurance system, but the thing is we know ways to deal with moral hazard, that is, having deductibles and having copayments, the standard things that you have on consumer insurance policies. We can have those kinds of features on a Government guarantee. But we can only do that if it is an explicit guarantee. If it is an implicit guarantee, we do not have any protection against moral hazard. If we are worried about moral hazard, we really actually have to have an explicit guarantee and then try and be smart about how we do it.

Senator MERKLEY. Explicit guarantee with firm regulatory standards avoids the challenges that Mr. Wallison was speaking to.

My time is up. I will just mention two things. I cannot ask for a response now, but one is we subsidize mortgages in so many different ways, with the home mortgage interest deduction, potentially with downpayment assistance to get people into loans, this informal guarantee of securities, and I would be very interested in following up afterwards with any data that compares the return on the investment in these different forms of subsidies.

Thank you.

Chairman JOHNSON. Senator Warner.

Senator WARNER. Thank you, Mr. Chairman, and I wish I had been here for the beginning of the hearing, and I think as Senator Corker mentioned, this is a spirited area where we are going to have to find some common ground.

I would concur with the basic notion that I imagine many of my colleagues have said. At this point we have got—whatever we think about GSEs, the percentage now is too high. How do we do this—how do we—whether we completely unwind or partially unwind—do it in a way that does not totally disrupt?

I guess one of the questions I would start with, Dr. Jaffee—and it is good to see you again, Peter. We spent a lot of time together in discussions on Dodd-Frank. If we look at a nonguarantee system—and then, frankly, I would like to hear everybody on this. Some folks have pointed to the European covered bond approach. But aren't we frankly seeing, somewhat to Professor Levitin's position, that while there is no formal guarantee in the covered bond approach, you have this implicit guarantee with these large financial institutions that become too large to fail so you are back into a quasi-Government guarantee, whether explicit or implicit?

Mr. JAFFEE. Well, I am very pleased you asked that because I was hoping to have an opportunity to indicate how much I disagree with Professor Levitin's position on that. I believe there is no evidence of any implicit guarantees or bailouts of any European banks relating to their covered bond issues. Those bonds are all rated AAA. They have been rated AAA from the day they were issued. I know of no down-rating of any of them.

At the key point of the crisis, there was a temporary liquidity blip where some investors simply got worried, and so the spreads on these bonds are typically 20 basis points above the sovereign debt of those countries. I suspect today they are below the sovereign debt of some of those countries. But those 20 basis points blipped up to 75 basis points. Not a huge amount. The European central bank said this is wrong, the bonds are completely safe. They bought a few of them, and the spreads went right back down to the 20 basis points.

The system worked with very safe mortgages, and the whole system agrees on that. The borrowers understand that you have to have downpayments, you have to have the income, and you cannot expect to default. It is not a system in which you hand off the key if the prices do not go your way. The bankers understand that they are going to be the—they are going to be holding these bonds on their balance sheet, but issuing them with covered bonds, with dedicated debt. And the Government understands that the system is going to work because they do not want the costs of foreclosure and default as we have just faced here. And the system does work. It has worked perfectly throughout this period, and I know of no problems.

The problem here in the United States, I will just quickly say, is that agencies like the FDIC have stood in the way of American banks creating these, and the FDIC's position is if we get a bank in trouble, we do not want them to have issued a lot of covered bonds because the mortgage assets are then dedicated to those bond holders, and we, the FDIC, think that is going to make our life tougher. That assumes that those mortgages would have been there in any case. That is not what happens in Europe. The mortgages that we securitize are actually held on the balance sheet. They are very safe, and the covered bond system works. And I hope we move——

Senator WARNER. Thank you. Other comments on this, please? Yes, everybody, if we could.

Mr. WALLISON. Well, I will just make a comment.

Senator WARNER. Relatively quickly, because I would love to get in one more question before my time is up.

Mr. WALLISON. I have heard the same argument that you made, Senator, and I do think it is a significant argument in the sense that if the largest banks in the United States are implicitly guaranteed in some way, then you might be creating a system with covered bonds that, in fact, results in some sort of Government backing.

However, the securitization system in the United States does not involve that, and one of the really interesting and valuable things about the securitization system is that anyone can participate. You do not need a lot of capital to do it. So the small banks can participate in securitizations as well as the large banks, and they do not have to sell to the large banks. They can also form cooperatives of their own in order to take advantage of the high-quality mortgages that they are creating.

So this is a complicated issue, and I would love to spend some further time on it.

Senator WARNER. Please.

Mr. LEVITIN. Very briefly, I just want to respond to what Professor Jaffee said. If you look at page 8 of my written testimony, I detail what happened in Germany and what happened in Denmark where the implicit guarantee actually became explicit, that Germany and Denmark both guaranteed the liabilities of some of their covered bond issuers. And in Denmark, yes, it was——

Senator WARNER. That was at the beginning of the crisis, wasn't it?

Mr. LEVITIN. That was in October 2008. And you can say, well, that was just a response to liquidity. Well, whatever it was, it showed that the Government would intervene to hold up this market, whether because of credit risk or liquidity. Now, it may be a guarantee only for catastrophic risk, but that is a guarantee right there. And, you know, in Denmark, it was not formally a guarantee of the covered bonds. It was a guarantee of the issuers. But because there is recourse to the issuers, that means that it functions as a guarantee of the covered bonds.

Mr. GREEN. To some extent I was going to say what Professor Levitin just said, but the other point is that Germany and Denmark are heavily regulated mortgage markets, and, you know, Government intervention could take many forms, and one of them in that if the Government says you may only do mortgages that have certain features to them, I would call that pretty serious Government intervention. So the idea that there is a mortgage market that does not have Government involvement is a statement I have a problem with.

The other thing is the Danish mortgage bonds have a feature that is very friendly to consumers, and I think it is worth thinking about. But, again, it means that the default rates are going to be low, which is that consumers can basically buy their mortgage back at the market value of the mortgage at any time. That is one of the attractive things about it.

In the U.S. context, what that would mean is if you are in Corona, California, where house prices have fallen 70 percent and the market judges that, therefore, your mortgage's value is only worth 30 percent of the par value, you as the borrower can buy it back and sell your house and actually be at least at water if not above water. And that is an attractive feature, but that is a very consumer-friendly feature that, again, is the result of Government decisions about how these things were designed.

Senator WARNER. Thank you, Mr. Chairman. The only thing I would just ask, I hope as we explore this area—and I know today was about Government guarantees, and I would look forward to kind of continuing and trying to get educated on this. I would love to see us look not only at the European model, but I would also like us to see what has become an article of faith and something I would like to make sure there is still a product in terms of a 30-year loan. I do think there are a lot of lessons that we can learn from our neighbors to the north in Canada where we did not have the kind of expectation around the Canadian market, the pricing around mortgages, the motion more that they were 15-year rather than 30-year. I really hope we will kind of get a chance to dig into all these things because I do think, whether we like it or not, this crisis' overhang continues to be with us. I do not think we have sorted through it well, and I think we ought to look at all the options on the table. Thank you for giving me this question.

Chairman JOHNSON. Senator Vitter.

Senator VITTER. Thank you, Mr. Chairman, and thanks to all of our witnesses.

Let me ask you all this question: It seems to me in the last decade the implicit guarantee by Fannie and Freddie was certainly closely related, a major or a significant cause of the decline in underwriting standards. They are not a coincidence, I do not think. If that is the case, how would we move to an explicit guarantee and somehow move in the opposite direction regarding real underwriting standards? That seems pretty uphill, pretty unnatural.

Mr. GREEN. Sure, well, I think it is worth thinking about how Fannie and Freddie behaved, again, before the crisis. If you look at how they did underwriting through, let us just say, the late 1990s, it was pretty robust underwriting. They had models that related FICO score, loan-to-value ratio, income, reserves, time in job, et cetera, to default probability. And they came up with cutoffs as a result of that, and they stuck to that quite well for a very long period through their existence.

I think there was a long period of time when they had the implicit guarantee where they had robust underwriting.

What seemed to happen is roughly in 2003 or 2004 they were losing market share to the private market. If you look at Federal flow of funds reports, this is pretty clear. And shareholders were screaming, and this is the problem, and so they followed the market in in having their underwriting standards deteriorate.

But that said, one of the mechanisms they used was buying AAA tranches of subprime mortgages, and they should not have done that, and somebody should have stopped them from doing that. But, on the other hand, there was also somebody buying lower tranches of these things as well, and these somebodies were people like Lehman Brothers. And there was an understanding—you know, I think Professor Jaffee is correct, that we said, OK, you make these risky bets and you lose and you are done, OK. But after Lehman Brothers collapsed, what we had is other investors in these lower tranched securities, and we did not let them fail because we decided the systemic risk for doing so would be too great.

So I think to pin it all on the implicit guarantee is very difficult because we went for so many years having it with pretty good underwriting.

Mr. WALLISON. Let me contradict what I just heard because it is not true at all that their underwriting was good, after 1992, especially after the affordable housing requirements were imposed on them. If you look at the data, you can see Fannie Mae and Freddie Mac were buying subprime and other low-quality loans right through the 1990s, and by the year 2000, in fact, Fannie Mae was offering a no-downpayment loan. Large proportions of their loans were 3-percent downpayment or less. In other words, they were already the cause of the decline in underwriting standards, and that eventually infected the private markets. But in the end, we had 27 million subprime or other low-quality loans in our financial system; that was half of all mortgages and two-thirds of those weak mortgages were on the books of Fannie Mae and Freddie Mac and other Government agencies, all of which, of course, were backed by the Government.

So it is a very important relationship that you have pointed out between a Government guarantee and poor-quality mortgages because the investors in those mortgages do not care about the quality of the mortgages as long as they have a Government guarantee.

Senator VITTER. And before the rest answer, let me just insert, I think another factor is the CRA-type mandate Congress has put out there, which also has not changed. So I am just wondering how we do not change that mandate, we move from implicit guarantee to explicit guarantee, and all of a sudden we expect underwriting standards to move in the opposite direction. It does not strike me as very natural.

Dr. Jaffee.

Mr. JAFFEE. Yes, well, that is exactly what I would have wanted to say. I think it is inevitable that a switch to a Government guarantee program is going to lead to lower underwriting standards. I mean, the proposals that are available publicly now usually start off with the right words. They say, "These are going to be prime mortgages, 20-percent downpayment, very suitable income-to-debt ratios." And, of course, then you could ask the question: Well, if they are so good, why do we need a Government guarantee at all? But the true answer—and if you now look in the details of these proposals—is, well, no, we are also going to have a 10-percent downpayment loan, and we will have a 5-percent downpayment loan, but we are going to charge actuarial premiums. Well, that is going to last for 2 minutes because as soon as the borrowers say, "Well, wait a minute. This is a Government program, and I only have 10 percent down, and you are telling me that I have to pay more on my mortgage than my fat cat friend. No way." In all of the experience—I mean, the National Flood Insurance Program is a classic example. Congress passed legislation that on the surface of the words was perfect. There would be risk-based premiums, it would be self-funding, all the right things. And what do you discover? As soon as there is a big flood, Katrina, they are $20 billion in the hole, and what you discover is the premiums that—the agency now admits the premiums were half of what they should have been. They had just the opposite of risk-based premiums. They actually gave benefits to people that had the most risk because they lived on the Mississippi River. And I believe it is inevitable that that is going to happen again.

Mr. LEVITIN. First, I would disagree about the statement that the implicit guarantee was causing the underwriting decline. The market leader in weak underwriting was the nonguaranteed private label securitization market. Now, Mr. Wallison points out that the GSEs were buying what he calls "weak loans." I think we need to be careful about exactly what we are calling weak loans because not every weak loan is the same. My understanding of how Mr. Wallison kind of reaches his figure is he is looking at loans that lack some—let us say loan-to-value ratio, documentation, FICO score, or some category like that, do not look like a perfect prime loan. That is perfectly fine if he wants to count them that way. But there is a difference between a loan that has, you know, a low LTV and a high FICO score and limited documentation and a loan that has high LTV, low FICO score, and limited documentation. Three dings is much worse than one ding. And the GSEs were not buying the three-ding loans. They were buying the one-ding loans. So those were the three-ding loans, and that is where we really saw the market go off the cliff. That was in the private label securitization market.

Two other comments. I think it is important that we remember the example of the FHA. There are plenty of problems with FHA and how it is run, but FHA has an explicit guarantee, it prices for it—not perfectly—but, you know, that market has not tanked. And

FHA ceded market share because it did not have private shareholders trying to get in competing for market share. That is what saved FHA.

Finally, on the Community Reinvestment Act, there is a Federal Reserve study about the impact of the Community Reinvestment Act on mortgage lending. I think it is probably the best thing out there on this. And what it shows is pretty clearly the most aggressive lenders were either not subject to the CRA or the aggressive loans they were making were not—they were not getting CRA credit for them because they were making them outside of their CRA assessment area.

So, you know, I think it is a little difficult to pin the blame on the CRA for the excesses of the private label securitization market in particular.

Senator SHELBY. Mr. Chairman.

Chairman JOHNSON. Senator Shelby has a closing observation.

Senator SHELBY. Thank you, Mr. Chairman.

First of all, Professor, it is my understanding that the Congressional Budget Office's recent estimates show that when market risks are incorporated, FHA guarantees are underpriced by almost $8 billion, for the record.

Now, where are we today? I think this has been a good hearing, Mr. Chairman. I think that we have got some different voices here, which we need. What is all this about and where are we? We have got a horror movie. And what is a horror movie? It is the GSEs, it is sitting in the lap of the taxpayers and growing. By conservative estimates, I understand, the taxpayers are going to eat a third of a trillion dollar, maybe a half a trillion dollars. Are we going to repeat this again? Are we going down that same road? Have we learned anything? I do not know. You know, I think this is a healthy discussion. I hope we have. But the CRA—I want to pick up on Senator Vitter. I tried to repeal the CRA right here in this Committee, because what we are doing, we are telling the market to make these loans for political reasons. Loans should be made on risk. I mean, it is nice to have a home. You know, we pushed the home ownership to the limit. We pushed the deal where, oh, they had equity in their home because prices were rising and they were borrowing second mortgages on this, home equity loans. It helped the economy temporarily.

So we got that horror movie where we are, and I hope we will not repeat it. Is it going to be tough political answers? I do not see any quick answer to this. But I hope we do not go down that same road. God, I hope and pray.

Thank you, Mr. Chairman.

Chairman JOHNSON. Before I close, I would like to correct a statement made early in this hearing. Congress did not appropriate $20 billion to the Flood Insurance Program. This may be the confusion of the Flood Insurance Program with the supplemental appropriations for FEMA.

I would like to thank the witnesses for joining us today. This issue of the Government guarantee is one that will continue to weave itself into all our discussions about the future of the housing finance system. It is clear that our priorities for market access, liquidity levels, and the types of mortgage products available will help our options going forward.

The hearing record will remain open for 7 days if Senators would like to submit statements or additional questions for the record.

This hearing is adjourned.

[Whereupon, at 11:37 a.m., the hearing was adjourned.]

[Prepared statements and additional material supplied for the record follow:]

PREPARED STATEMENT OF RICHARD K. GREEN

DIRECTOR AND CHAIR, USC LUSK CENTER FOR REAL ESTATE, UNIVERSITY OF SOUTHERN CALIFORNIA

SEPTEMBER 13, 2011

Chairman Johnson and Senator Shelby, thank you for allowing me to be part of this distinguished panel today. My name is Richard Green, and I am the Lusk Chair in Real Estate and the Director of the Lusk Center for Real Estate at the University of Southern California, where I am also Professor of Policy, Planning and Development and Professor of Finance and Business Economics.

As you know, I have been asked to discuss whether the U.S. mortgage market requires a Federal guarantee in order to best serve consumers, investors and markets. I will divide my remarks into four areas:

(1) I will argue that the United States has had a history of providing guarantees, either implicit or explicit, regardless of its professed position on the matter. This phenomenon goes back to the origins of the republic. It is in the best interest of the country to acknowledge the existence of such guarantees, and to price them appropriately before, rather than after, they become necessary.

(2) I will argue that in times of economic stress, such as now, the absence of Government guarantees would lead to an absence of mortgages.

(3) I will argue that a purely "private" market would likely not provide a 30-year fixed-rate prepayable mortgage. I think this is no longer a particularly controversial statement; what is more controversial is whether such a mortgage is necessary—I will argue that it is.

(4) I will argue that in the absence of a Federal guarantee, the price and quantity of mortgages will vary across geography. In particular, rural areas will have less access to mortgage credit that urban areas, central cities will have less access than suburbs. Condominiums already are treated less favorably than detached houses, and this difference is likely to get larger in the absence of a guarantee.

Before discussing the substance of my remarks, I should make some disclosures. First, I worked as a Principal Economist and then Director of Policy Strategy for Freddie Mac between September of 2002 and January of 2004. Part of my compensation for that work was restricted shares in the company. I never sold my shares in Freddie Mac, and I have no expectation of ever seeing them have material value. I think it appropriate that common shareholders were substantially wiped out by the Government conservatorship of the company. Second, I have performed research with two Fannie Mae employees, Eric Rosenblatt and Vincent Yun, for an academic paper. The only compensation I received for this was intellectual satisfaction. Finally, when the Fannie Mae Foundation was publishing Housing Policy Debate, I received compensation for reviews I wrote for the publication.

I. The United States Has a Long History of Providing Ex Post (After the Fact) Guarantees, As Well As Other Guarantees

One could reasonably argue that the United States was born from a bailout. One of the most famous compromises in U.S. history was a deal negotiated among Hamilton, Jefferson, and Madison for the new Federal Government of the United States to assume the Revolutionary War Debts of the Continental Army and the individual States. While Jefferson would later write that he regretted the compromise (probably because he saw Virginia as a net loser on the deal), it helped bind the States together. Moreover, because of Hamilton's financial acumen, Assumption probably allowed States and the Continental Army to pay less in interest costs than they otherwise might, and so allowed the country to begin on a strong financial footing. [1]

The Transcontinental Railroad also received financing at least in part because of Government guarantees (as well as direct subsidies). While the railroads were built by private companies (the Central Pacific and the Union Pacific), capital costs were financed by bonds that were explicitly backed by the Federal Government. While the backing was explicit, the equity investors in the railroads were not required to pay guarantee fees; profits were privatized while risk was socialized. In the end, the shareholders of both railroads lost their investments, but somehow the managers, including Coliss P. Huntington and Charles Francis Adams, obtained and retained great wealth.

More recently, of course, we have had many "private" institutions receive Federal backing, including commercial banks (who benefited from the Troubled Asset Relief

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[1] Ron Chernow, *Alexander Hamilton,* The Penguin Press: New York. Ch. 16.

Program (TARP) as well as the Federal Deposit Insurance Corporation (FDIC)), the "purely private" investment banks (who benefited from TARP), issuers of Asset Backed Securities (who benefited from the Term Asset Backed Securities Loan Facility (TALF)) and, of course, the Government Sponsored Enterprises. While one might argue that the GSEs have received more largess than the other private institutions, the fact is the Federal Government has shown, again, that it will intervene when large, systemically dangerous institutions are on the verge of collapse.

Furthermore, we still don't know the full extent of Government largess, because we don't yet know the potential cost of off-balance sheet assets that commercial banks may be forced to repurchase because of alleged misrepresentations.

In light of the fact the Federal Government cannot credibly commit to no-bailout policies (after all, TARP was the creation of a Republican administration), no matter what one thinks about the principle of Government guarantees, as a practical matter it makes sense to recognize them explicitly and to price them.

Recent evidence suggests that neither the public nor private sectors is particularly good at pricing risk (although the FHA program, which has performed remarkably well through the crisis, might be an exception). The Government should thus begin by pricing risk cautiously; perhaps more important, it should require institutions that might benefit from guarantees to hold capital. While market participants fear that higher capital requirements would raise costs to consumers, (1) such costs may be appropriate and (2) they may be actually be small. As financial institutions become less levered, their required return on equity should fall.[2] Indeed, because bankruptcy is costly, a policy that reduces the probability of bankruptcy, such as strong capital standards, could actually lower the total cost of capital for lenders. As we unfortunately know too well now, though, measuring capital is difficult, so guaranteed mortgage finance in future should require both fees and robust capital standards.

II. In Times of Economic Stress, Debt Markets Do not Operate in the Absence of Government Guarantees

Beginning with the Great Depression, the United States has faced at least four periods when private debt markets largely shut down—liquidity was so absent that spreads were not only wide, they were impossible to measure owing to the absence of transactions: the Great Depression; the double-dip recession of 1979–81; the Long-Term-Capital financial crisis; and the Great Recession of 2008–09.

In the aftermath of the banking crisis of 1930–33, mortgage lending shut down. As Ben Bernanke wrote in his classic paper[3]:

> because markets for financial claims are incomplete, intermediation between some classes of borrowers and lenders requires nontrivial market-making and information gathering services. The disruptions of 1930–1933 (as I shall try to show) reduced the effectiveness of the financial sector as a whole in performing these services.

In other words, the banking crisis was principally a liquidity crisis; lenders had a reluctance to make even good loans to each other. The passage also underscores the more ubiquitous problem with financial institutions: they are rife with incomplete markets. Even in the absence of Government guarantees, financial institutions have principal-agent problems, adverse selection problems, lemons problems, and pooling problems.

The Hoover administration created the Federal Home Loan Bank System and the Roosevelt administration created the Federal Housing Administration, the Federal Deposit Insurance Corporation, the Home Owners Loan Corporation and, later, the Federal National Mortgage Association to restore liquidity.

And restore liquidity they did. Figure 13 in Son and Lee[4] (which graphs data from Goldsmith 1955[5]) shows the sharp drop in liquidity between 1930 and 1933, and how it is restored in 1934. The Federal Home Loan Bank system was established in 1932, FDIC in 1933 and the Federal Housing Administration in 1934.

[2] Franco Modigliani and Merton Miller's eponymous and famous theorem predicts that the total cost of capital to a firm should be invariant to capital structure. F. Modigliani and M. Miller (1958) "The Cost of Capital, Corporation Finance and the Theory of Investment", *American Economic Review* 48(3): 261–297.

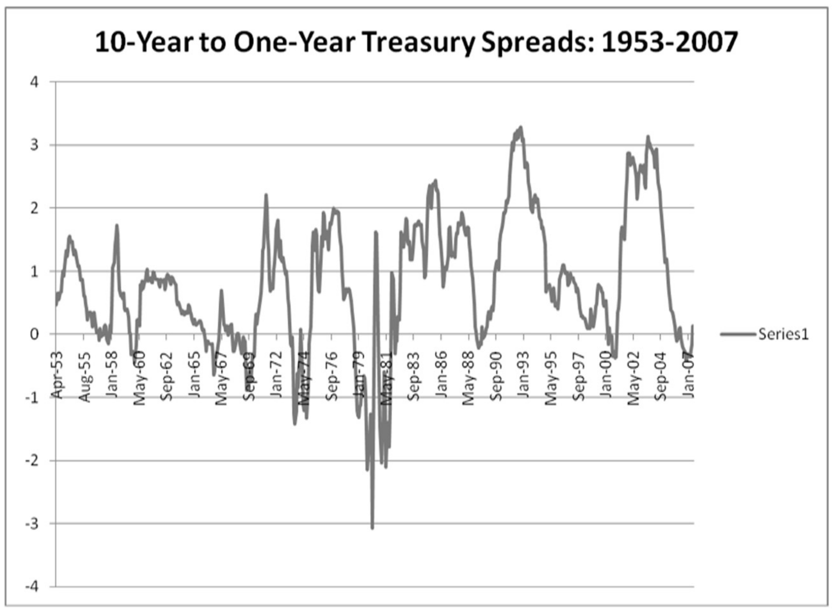
[3] Ben S. Bernanke, "Nonmonetary Effects of the Financial Crisis on the Propagation of the Great Depression" (1983). *American Economic Review*, 73(3): 257–276.

[4] Jin Son and Keun Lee (2010), "Financial Crisis and Asset Market Instability in the 1930s and 2000s: Flow of Funds Analysis". *http://apebhconference.files.wordpress.com/2009/08/son-n-lee.pdf*

[5] Raymond W. Goldmith (1955), *A Study of Savings in the United States*. Princeton University Press: Princeton.

While one does not want to make *post-hoc ergo prompter-hoc* arguments, one could argue that the new Federal Institutions allowed for the possibility of price discovery, which in turn brought about some restoration of liquidity.

More recently, the double-dip recession of 1979–1981 led to a diminution of liquidity in the mortgage market. Between 1977 and 1982, net lending from savings institutions, the primary source of mortgage finance, dropped by 67 percent.[6] At about this time, and not coincidentally, Government Sponsored Enterprise lending expanded by a factor by 3. GSE-backed Mortgage Backed Security lending quadrupled during this time, and GSE portfolio lending more than doubled. Both Savings and Loans and Fannie Mae were technically insolvent over this period, but the Federal Government exercised forbearance, which could be looked at as a whispered guarantee.



We should note that mortgage institutions were troubled less by credit risk than interest rate risk: Savings and Loans as well as Fannie Mae had long-term mortgages on their balance sheets; they funded these mortgages with short-term debt. The yield curve between 1979 and 1981 was highly inverted (in fact, short term rates were higher than long-term mortgages by an unprecedented amount). One might take the view that while financial institutions have control of credit risk, they have no control over the short-term interest rate set by the Federal Reserve System. In any event, investors were apparently more comfortable with Freddie Mac and Fannie Mae's credit risk guarantees than depositors were with Savings and Loans.

Most dramatic was the Long-Term Capital Management Crisis, which was something of a rehearsal for the most recent crisis. When conduits for commercial mortgages shut down, Fannie Mae and Freddie Mac continued to lend. Anthony Sanders (no fan of GSEs) shows in a graph that the spread between Jumbo and Conforming Mortgage widened from 10 to 40 basis points in the aftermath of the Long-term Capital Financial Crisis.

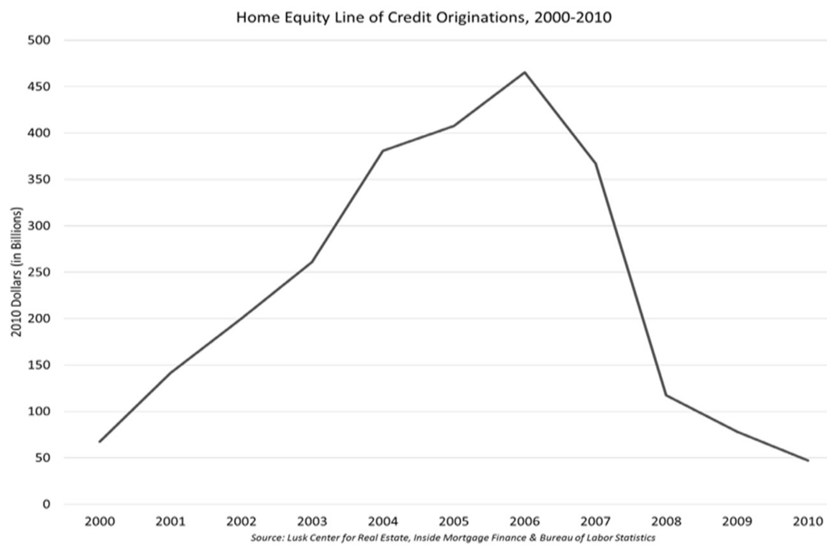
Of course, in the current environment, the Government sponsored enterprises, which are wards of the State, are the dominant sources of mortgage lending. It is frightening to think where housing markets, already at their weakest point since the Great Depression, would be in the absence of the GSEs. While one might argue that the lack of other lending arises from a private sector being crowding out by the public sector, the segments of the housing market which are not eligible for GSE

[6] *See*, Flow of Funds Accounts of the United States, Table F.1, line 40.

purchases have very nearly shut down. According to Inside Mortgage Finance, the prime jumbo mortgage originations have dropped by more than ⅚ since the peak, and in 2010 were at about ⅓ the level of any year before 2008.

Source: Lusk Center for Real Estate, Inside Mortgage Finance & Bureau of Labor Statistics

Home equity lines of credit, which are an important mechanism for the elderly to use housing wealth to smooth consumption, have seen similarly dramatic drops.



III. The 30-Year Fixed-Rate Mortgage Might Go Away in the Absence of Government Guarantees

There are two issues here: whether the U.S. long-term self-amortizing mortgage requires some sort of Government support, and whether it is important.

Counterfactuals are impossible to prove, but we do have some evidence that the GSEs mattered to making the long-term mortgage common. While such loans existed before the Home Owners Loan Corporate made them the standard instrument in the United States, they were not common. Moreover, as we look at other countries, we find that long-term fixed-rate prepayable mortgages are rare. So far as I can tell, Denmark is the only other country that has such mortgages, and while that market appears "private," it has heavily regulated, specialized institutions that issue that bonds that fund mortgages. When these institutions faced problems in 2009, the Danish government injected liquidity into them. And while there is much to praise about the Canadian mortgage systems, it too has Government involvement (most low-downpayment loans are supported by Government mortgage insurance) and is vulnerable to a particular type of risk: borrowers must roll over their debt every 5 years or so.[7] The current state of the commercial real estate Market underscores that maturity defaults—defaults that arise because borrowers cannot roll over debt when capital markets are troubled—are just as bedeviling as payment defaults.

David Min has a nice explanation of why the 30-year mortgage is good for consumers[8]:

> There are three major arguments in favor of continuing to emphasize the 30-year fixed-rate loan in the United States:
>
> - First, the 30-year fixed-rate mortgage provides cost certainty to borrowers, which means they default far less on these loans than for other products, particularly during periods of high interest rate volatility.
> - Second, the 30-year fixed-rate mortgage leads to greater stability in the financial markets because it places the interest rate risk with more sophisticated financial institutions and investors who can plan for and hedge against interest

[7] Thanks to Tsur Somerville of the University of British Columbia for making this point to me about Canadian mortgages.

[8] *See, http://www.americanprogress.org/issues/2010/11/housing__reform.html.*

rate fluctuations, rather than with unsophisticated households who have no such capacity to deal with this risk and who are already saddled with an enormous amount of financial burden and economic uncertainty.

- Third, the 30-year fixed-rate mortgage leads to greater stability in the economy because short-term mortgages are much more sensitive to interest rate fluctuations and thus much more likely to trigger a bubble-bust cycle in the housing markets. Indeed, there may be reason to believe that a primary cause of the recent housing bubble-and-bust cycle was the rapid growth of short-duration mortgages during the 2000s, which caused U.S. home prices to become more sensitive to the low interest rate environment created by Alan Greenspan's Federal Reserve.

I would add that the prepayable 30-year mortgage allows households to duration match assets and liabilities. Most households have two principal assets—their house and their human capital. Houses are long-term capital assets—and as such their values are sensitive to real interest rates. The 30-year mortgage allows households to hedge interest rate risk. This hedge isn't free—long-term interest rates are usually higher than short-term rates for a reason. But having the option of the hedge helps household mitigate risk.

On the other hand, the ability to freely repay a mortgage allows households to be mobile. If one needs to move from one State to another to take a new job, free prepayment reduces the cost of such a move. Once again, this option is not free—investors need to be compensated for the risk they take—but it helps households better manage risk.

We at business schools teach the importance of hedging duration risk. It is no less important for households than it is for financial institutions. The 30-year fixed-rate prepayable mortgage is the instrument that allows households to do so.

IV. In the Absence of a Guarantee, We Would Observe Differences in the Price and Availability of Mortgage Credit Across Communities

Some housing markets have many fewer transactions than others. It can be difficult to infer house prices, and therefore to assess mortgage risk in these markets.

Brent Ambrose and Richard Buttimer [9] write about how rural markets, where houses trade infrequently, might be ill-served in the absence of a guarantee:

> our analysis confirm[s] that the conforming rural market is closely tied to the conforming urban market, while the jumbo rural market is less closely tied to the jumbo urban market. We interpret this as evidence that GSE involvement in the rural market, while a relatively small portion of the overall GSE business, is, nevertheless, serving to provide rural conforming mortgage borrowers with improved access to credit, especially when compared to rural jumbo borrowers.

The problem rural markets face applies to central urban markets as well. Lang and Nakamura show how thin markets in urban centers make valuation more difficult and undermine liquidity in the lending market [10]

A ruthless economist might argue that this simply means that rural areas and central cities are obsolete places that "deserve" their second class status for borrowing or lending. But when lending is underprovided because of information problems, resources are being wasted, and a well-tuned policy that allows for lending on favorable terms can provide a more efficient outcome than the market alone.

There are times, moreover, when even the most attractive neighborhoods for lending find themselves without easy access to credit. We find ourselves at this such a time right now. Even though lenders are advertising jumbo mortgages, borrowers are currently finding it very difficult to obtain one.

To begin, the process is long—loan approvals are taking as long as 4 months, which essentially eliminates a spot market in housing. Second, as with the case of rural and inner-city markets, appraisals are an impediment to lending, because the thinness of markets is making it difficult to determine appraised values. Third, the underwriting standards have swung from being too lenient to being considerably harsher than they were in the 1990s or even the late 1980s, which, based on performance, was a period in which underwriting was strong. For example, lenders are often looking for reserves equal to 10 percent of the value of the house along with a 20 percent downpayment.

[9] *See,* Brent Ambrose and Richard Buttimer (2005), "GSE Impact on Rural Mortgage Markets", *Regional Science and Urban Economics,* 35(4): 417–443.

[10] *See,* W. Lang and L. Nakamura (1993), "A Model of Redlining", *Journal of Urban Economics,* 33(2): 223–234.

Perhaps such underwriting standards would be fine, were it not for the fact that they would prevent a substantial number of households from obtaining mortgage credit. As Peter Linneman and Susan Wachter [11] showed many years ago, the largest impediment to obtaining credit is not so much the ability to make monthly payments as it is to obtain a downpayment.

Professor Jaffee has argued that other countries (including Canada, Australia, and many European Countries) have home ownership rates as high as the United States despite having more onerous terms for borrowers, and that therefore the United States need not worry about making mortgage funds more difficult to obtain. [12]

The problem with this line of reasoning is that the income and wealth distributions in these countries are substantially more even than in the U.S. For example, according to the OECD, the top half of the income distribution in the U.S. has higher income than all but two other countries (the Netherlands and Luxembourg), the bottom quintiles income ranks 19th. The wealth distribution in the U.S. is even more skewed than the income distribution.

If these differences in wealth and income reflected differences in effort and talent, this would not be a source of concern, at least to me personally. But we know that intergenerational wealth is an important determinant of the income distribution, and we are a country where for many generations not all of us had equal access to capital.

According to the Federal Reserve's Survey of Consumer Finances, median wealth among non-Hispanic white families was $171,000 in 2007; among nonwhite and Hispanic families it was $28,000. It is not a coincidence that the home ownership rate for white households is more than 20 percentage points higher than for the remainder of the country—easier access to mortgage credit over the years allowed white Americans to build wealth more easily than nonwhite and Hispanic Americans. [13]

Differences in wealth—particularly home-owning wealth—from past generations had an impact on successor generations. Dalton Conley has used Panel Survey of Income Dynamics Data to show that the probability of a child attending college can be largely predicted by two things: whether her parents went to colleges, and whether her parents had home equity.

It is doubtful that the private market on its own can redress this inequality of wealth that arises not because of differences in effort across people, but because of differences in how previous generations were treated.

There are those who argue that it was the attempt to advance mortgage credit to minorities that led to our current condition—I do not accept that argument. The loans that have performed most poorly were originated by institutions that were not covered by the Community Reinvestment Act or the Affordable Housing Goals. Moreover, as Mr. Wallison [14] himself once noted, Fannie Mae and Freddie Mac did not do a good job of advancing credit to minorities or low-income neighborhoods. While this is to their discredit, it undermines that argument that their troubles arose because they made too many loans to underserved borrowers.

Indeed, part of the problem is that institutions that received no guarantee made no effort to assure their loans were suitable, and often steered borrowers away from vanilla 30-year fixed-rate products toward more dangerous products that were larded with fees. These were more profitable in the short-term, but exploded in the slightly longer-term. Such recent past behavior does not support the conclusion that Government guaranteed loans are more menacing than those produced in the purely "private" sector.

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[11] P. Linneman and S. Wachter (1989), "The Impacts of Borrowing Constraints on Home Ownership", *AREUEA Journal* 17, 389–402.

[12] *See*, Dwight Jaffe (2010), "Reforming the U.S. Mortgage Market Through Private Incentives", *http://research.stlouisfed.org/conferences/gse/Jaffee.pdf.*

[13] The Government itself discriminated against certain neighborhoods based on racial characteristics for many years. The Home Owners Loan Corporation and the Federal Housing Administration had maps that green-lined neighborhoods that were considered desirable and red-lined those that were not. Neighborhood "desirability" was determined in part by its ethnic and racial make-up. In a recent law review article, Thomas Mitchell, Stephen Malpezzi, and I ("Forced Sale Risk: Class, Race, and the 'Double Discount'", *Florida State University Law Review*, Vol. 37: 589-68 (2010)) moreover found that many African Americans had their home equity stripped through partition sales and sheriff's sales.

[14] *See, http://www.aei.org/article/23974.*

PREPARED STATEMENT OF PETER J. WALLISON

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This testimony is in three parts.* First, I address a Government guarantee for housing finance in the context of its adverse effects on the U.S. debt picture, on U.S. taxpayers, and on the overall health of the U.S. economy. In the second section, I address the arguments that are generally made in support of a Government-backed system and show that they are without merit. In the third section, I briefly discuss how a fully private system for housing finance should be structured.

I. Problems Associated With a Government Guarantee of the Housing Finance Market Effect on U.S. Debt

Although the Government's overall debt position is not an issue that is usually part of the debate on housing finance policy, the fiscal position of the United States has deteriorated so seriously in recent years that the question whether to increase the national debt in order to support the U.S. housing market has now become highly germane.

The CBO recently estimated—even after the recent debt extension agreement—that if current policies are pursued the national debt will balloon from $14.3 trillion today to $23 trillion in 2021. Virtually all proposals for U.S. Government assistance to the housing finance market assume that it will involve an explicit Government guarantee, but even if this guarantee is only implicit—as it was with the Government sponsored enterprises (GSEs) Fannie Mae and Freddie Mac—it will make no significant difference except in the budget numbers. As my AEI colleague Alex Pollock has pointed out,[1] the off-budget debt of the various Government agencies—primarily Fannie Mae and Freddie Mac—currently totals $7.5 trillion, but the bailout of Fannie and Freddie proved beyond question that this debt is every bit a part of the Nation's debt as the securities are issued by the Treasury.

So, without any change in policies and without any further increase in the GSEs' debt, the national debt will reach $30 trillion in 10 years. With this background, it is hard to believe that there is actually a viable campaign to have the Government support the housing market once again. At a time when Congress is having great difficulty trying to reduce the debt by finding places where spending can be cut, it is astonishing that some in the private sector can appear before Congress to ask for yet more debt in support of the housing market, a sector of the economy that could function perfectly well without any Government backing.

Accordingly, in considering whether the Government should back housing finance, the first consideration this Committee should have in mind is whether it would be good policy at this time to add to the U.S. Government's financial obligations.

Effect on the Taxpayers

There is no doubt that this campaign for Government backing, if successful, will benefit certain groups—primarily the ones who are doing the campaigning. However, there is one group—U.S. taxpayers—who never seem to get a second thought when these campaigns are run. Nevertheless, it is the taxpayers who inevitably have to bear the burden of the subsidies that the Government hands out through its support for housing finance.

The history here is consistent; the taxpayers are always left holding the bag. There's an explanation for this: the Government is never fully compensated for its risks. In the 1930s, for example, Congress set up the Federal savings and loan system (S&Ls), insuring their deposits—and giving them advantages over banks in attracting funds—so that they could finance mortgages at low rates. In adopting this program, the Government took substantial risks for the taxpayers' account. S&Ls were expected to borrow money through short-term deposits but make long-term mortgage loans, an obvious prescription for disaster that only worked as long as interest rates were controlled by the Government. When the capital markets were freed of controls, so that funds could flow where they were most useful, the Government could no longer maintain controls on interest rates, and the higher rates they had to pay for funds drove many S&Ls into insolvency. The Government could have been compensated for the risk it was taking on the S&Ls by raising the premium

* The views expressed in this testimony are those of the author alone and do not necessarily represent those of the American Enterprise Institute.

[1] Alex J. Pollock, "The Government's Four-Decade Financial Experiment", The American.com, July 13, 2011, *http://www.american.com/archive/2011/july/the-government2019s-four-decade-financial-experiment.*

for their deposit insurance. But this would have raised the cost of their mortgage loans, defeating the purpose of the S&Ls. So when the consequences of the Government's risks unfolded in the 1980s the taxpayers had to pick up a $150 billion tab.

Parenthetically, it should be noted that even the interest rate controls that made the S&L system work were another way of assessing the taxpayers. The deposit rate ceilings limited what depositors could earn on their savings, and penalized them even more directly when inflation caused prices and market interest rates to rise in the 1970s.

Now the taxpayers are being assessed to bail out Fannie and Freddie. These two Government sponsored enterprises (GSEs) became insolvent because Congress materially increased their risks in 1992 by requiring them to acquire what were called affordable housing loans. These loans were to be made to borrowers at or below the median income in the places where they lived. Initially, 30 percent of the mortgages Fannie and Freddie were required to buy had to meet the affordable housing goals. However, the Department of Housing and Urban Development was given authority to administer the program, and by 2007 it had increased the goals so that 55 percent of all mortgages the GSEs bought had to be affordable housing loans. HUD also added subgoals that required the purchase of mortgages made to borrowers who were 80 percent and in some cases 60 percent of the median income in their communities.

It is of course possible to find prime mortgages among borrowers who are at or below the median income where they live—and maybe even borrowers who are at 80 percent or 60 percent of the median income—but not when more than half of the GSEs' loans had to be made to borrowers who frequently had blemished credit, lacked funds for downpayments and did not have the steady incomes necessary to maintain home ownership. Accordingly, in order to meet the affordable housing goals, Fannie and Freddie had to take significant risks on mortgage quality, and those risks—which turned into losses when the housing bubble deflated—eventually caused their insolvency. Here is a quote from Fannie Mae's 2006 10-K that makes exactly this point:

> [W]e have made, and continue to make, significant adjustments to our mortgage loan sourcing and purchase strategies in an effort to meet HUD's increased housing goals and new subgoals. These strategies include entering into some purchase and securitization transactions with *lower expected economic returns than our typical transactions.* We have also relaxed some of our underwriting criteria to obtain goals-qualifying mortgage loans and increased our investments in higher-risk mortgage loan products that are more likely to serve the borrowers targeted by HUD's goals and subgoals, *which could increase our credit losses.* [emphasis supplied.]

The GSEs' regulator, the Federal Housing Finance Agency (FHFA) estimated several months ago that the losses these two firms will eventually suffer will range from $221 billion to $363 billion, but the continued deterioration of the mortgage market since that estimate was made suggests that the taxpayers will eventually have to pay more than $400 billion to make up the GSEs' losses.

Again, the Government could have been compensated for the risks it was creating for Fannie and Freddie. It was well-known that they were regarded in the capital markets as Government-backed, and for that reason were the beneficiaries of low borrowing costs. Accordingly, there were many proposals that the Government charge Fannie and Freddie a guarantee fee, so in the event of their failure the Government could have been compensated for the costs it would have to bear. But as in the case of the S&Ls these proposals to compensate the Government and protect the taxpayers were strongly opposed in Congress (and by the GSEs themselves) because they would increase the cost of mortgages. So in a very direct way the taxpayers are now paying for the risks that the Government required Fannie and Freddie to take. The Administration itself recognizes this problem. As it noted in its February 11 statement on housing finance policy, "Political pressure to lower the price of Government support increases the odds that the Government will misprice risk and put taxpayers at risk." [2]

The Government also imposes costs on the taxpayers because of its lack of discipline in maintaining the necessary reserves for insurance funds that are intended to pay for contingent losses when they occur. Government loves to describe its policies as insurance—insurance sounds so stable and sensible—but it doesn't do the one thing that private insurers do to cover their risks: it does not maintain adequate contingency funds. As the Government's funds accumulate, the argument is made

[2] Departments of Treasury and HUD, Reforming America's Housing Finance Market, 26.

that times are different, that the fund is large enough, or even that the industry paying the premium is strapped for cash or investment capital. These pressures cause the Government to let it ride, to refrain from collecting the necessary fees or premiums. This has occurred with the National Flood Insurance Program, [3] the Pension Benefit Guaranty Corporation, [4] the FHA, [5] and the Federal Deposit Insurance Corporation (FDIC).

Recent FDIC experience is fully consistent with Congress's reluctance to collect the necessary premiums in any insurance program. When the deposit-insurance system was reformed in 1991 in response to the failure of the FSLIC, Congress placed a limit on the size of the fund that the FDIC could accumulate to meet the demands of a future crisis. Since 1996, the FDIC has been prohibited by law from charging premiums to well-capitalized and stable institutions. As a result, between 1996 and 2006, institutions representing 98 percent of deposits paid no deposit-insurance premiums. In 2009, FDIC chair Sheila Bair observed: "An important lesson going forward is we need to be building up these funds in good times so you can draw down upon them in bad times." [6] Instead, once the bad times hit, the FDIC became insolvent and was forced to raise its premiums at the worst possible moment, thereby reinforcing the impact of the down cycle.

Finally, it should be noted that to the extent that Government guaranteed mortgage-backed securities (MBS) are available they compete with Treasury securities. Many investors prefer them to treasuries because they represent virtually the same risk but offer a higher yield. Under these circumstances, the Treasury must pay a higher rate of interest than it would otherwise have to pay if there were no competition in the market. A recent Fed paper suggested that by purchasing GSE MBS (and thus taking those securities out of competition with the Treasury 10-year note) the Fed had reduced the interest rate on the 10-year note by as much as 30 to 100 basis points. [7] If correct, this is an enormous amount and in effect another cost of a Government housing finance guarantee that will have to be paid by the taxpayers.

Effect on the Economy as Whole

Bubbles are a familiar phenomenon in any economy. They occur in the prices of many commodities from time to time, and even occur in the stock market, but they are particularly pervasive and long-lived in housing. In the last 30 years, there were housing price bubbles in 1979 and 1989—each of which lasted about 3 or 4 years—and a gigantic 10 year bubble between 1997 and 2007. There is good reason to believe that these housing bubbles are the result of Government involvement in housing finance.

Among the purposes of past Government support for the housing market was to assure a steady flow of funds for housing. There is no particular reason why housing—as opposed to any other area of the economy—might require a steady flow of funds. Automobiles, food and other retailing, mining, high tech, and corporate finance generally do not require steady flows of funds and have survived and prospered quite well.

However, one of the effects of Government support for a steady flow of funds to housing is that it lowers the financing risks for the homebuilders and others in the

[3] "FEMA Administrator Craig Fugate says the debt results partly from Congress restraining insurance rates to encourage the purchase of coverage, which is required for property owners with a federally backed mortgage. . . . 'It is not run as a business,' Fugate said. Congress' Government Accountability Office said in April that the program is 'by design, not actuarially sound' because it has no cash reserves to pay for catastrophes such as Katrina and sets rates that 'do not reflect actual flood risk.' Raising insurance rates or limiting coverage is hard. 'The board of directors of this program is Congress,' Fugate said. 'They are very responsive to individuals who are being adversely affected.'" (Thomas Fink, "Huge Losses Put Federal Flood Insurance Plan in the Red", *USA Today,* August 26, 2010.)

[4] As of the end of FY2010, the Pension Benefit Guaranty Corporation (PBGC) reported a deficit of $23 billion. "In part, it is a result of the fact that the premiums PBGC charges are insufficient to pay for all the benefits that PBGC insures, and other factors." Pension Benefit Guaranty Corporation, "2010 PBGC Annual Report," *www.pbgc.gov/about/ar2010.html* (accessed January 14, 2011).

[5] Barclays Capital estimates that the FHA has drastically underpriced the risk of its guarantees and could face losses of up to $128 billion. Barclays, "U.S. Housing Finance: No Silver Bullet", December 13, 2010.

[6] Center on Federal Financial Institutions, "Federal Deposit Insurance Corporation", August 10, 2005, *www.coffi.org/pubs/Summaries/FDIC%20Summary.pdf* (accessed January 14, 2011). *See also,* Congressional Budget Office, "Modifying Federal Deposit Insurance", May 9, 2005, "Currently, 93 percent of FDIC-insured institutions, which hold 98 percent of insured deposits, pay nothing for deposit insurance."

[7] Joseph Gagnon, Matthew Raskin, Julie Remache, and Brian Sack, "Large-Scale Asset Purchases by the Federal Reserve: Did They Work?", *FRBNY Economic Policy Review,* May 2011, p. 41

business of producing housing. Lowered risks encourage more homebuilding activity, because it reduces the likelihood of loss in the event of a market downturn. This, in turn, encourages speculation and increases the likelihood that housing bubbles will develop. When these bubbles eventually deflate, the losses they create represent a misallocation of capital that could have been used more efficiently elsewhere. Occasionally, as in 2008, the losses that occur as a result of a bubble's collapse can cause a financial crisis.[8]

The Government's role in housing finance also has a negative effect on competition and thus reduces innovation and raises costs. The fact that the Government cannot or will not price for risk should be an important clue about the distorting effect its guarantee will have on competition. For the reasons outlined above, the Government's charge for supporting the housing market will be lower than the actual risk would demand, so its backing operates as a subsidy.

This happened with Fannie and Freddie. Because they were seen as Government-backed, they were beneficiaries of lower funding costs in the market, and this allowed them to drive all competition from the secondary mortgage market. As a result, until they were felled by the affordable housing requirements, the GSEs' profits were extraordinarily high and their efficiencies and innovations low. In addition, they were not subject to market discipline because lenders did not believe that as Government-backed enterprises they represented any significant risk.

Thus were Fannie and Freddie enabled to take the risks required by the affordable housing requirements without any scrutiny by the private market. The real costs to society appeared later. The same thing will happen with any Government program that backs housing finance with a guarantee of any kind, whether it covers the issuers of mortgage-backed securities (MBS) or only the MBS. In both cases, competition will be reduced and market discipline impaired.

Accordingly, apart from its adverse effects on the debt and the taxpayers, Government support for housing finance also tends to increase speculation in homebuilding and related activities, causing housing bubbles, waste of capital resources, and impairment of the benefits of competition. This reduces, rather than increases economic growth and employment.

II. The Arguments Advanced in Support of Government Guarantees Have no Merit

Having shown that Government guarantees for housing are affirmatively harmful for the country's fiscal position, for taxpayers and for the U.S. economy, I will now discuss the likely form that any such guarantees will take, and the various reasons that the proponents of Government guarantees advance to support of their position. These, I will show, are without merit.

The Likely Form of a Government Guarantee Program

The spectacular failure of Fannie and Freddie has caused many proponents of Government guarantees in housing finance to revise the structure of their proposals. Instead of guaranteeing the issuers of MBS like Fannie and Freddie, the new more sophisticated idea—including Option 3 in the Administration's February 11 policy statement—is to have the Government's guarantee attach only to the MBS and not to the issuers. These plans would obligate the Government to pick up losses only after the capital of an MBS issuer has been exhausted and would require the issuer to pay a fee to the Government to cover the Government's risks. This idea is presented as though it will prevent losses similar to those that resulted from the operations of Fannie and Freddie; the implicit suggestion is that if only the MBS are guaranteed the Government's risks will be reduced and the likelihood of taxpayer losses will be minimized.

This is an illusion, for several reasons. First, as noted above, the Government cannot effectively set a fee to cover the taxpayers' risks on the Government's program. Even if Government had the incentives and capabilities to assess a proper fee, the assessment would be seen and attacked as an unfair tax on housing or on the borrowers who would have to pay higher interest rates. For example, when the Office of Management and Budget suggested near the end of the Clinton administration that Fannie and Freddie pay a fee for the Government's risk on its implicit backing of their obligations, the idea was immediately derided as a tax on home ownership, the Administration was inundated with protests from the housing industry, and the proposal was promptly abandoned.

Apart from whether the appropriate fee can be credibly established, history shows that Congress does not have the political fortitude to impose a fee that burdens

[8] *See,* Peter J. Wallison, "Dissent From the Majority Report of the Financial Crisis Inquiry Commission", January 2011, *http://www.aei.org/docLib/Wallisondissent.pdf.*

homeowners or the housing industry. In addition, it is fanciful to believe that the companies set up by the Government to perform a Government mission will not be viewed in the market as Government-backed. It is necessary only to point out that the GSEs' charter says explicitly that they and their obligations are not guaranteed by the Government, but when they became insolvent the Administration immediately took them over and assured creditors that they would be fully paid.

Similarly, as discussed above, even if the Government were to impose a fee of some kind, the political process would—as it has in the case of the FDIC and other "insurance" programs—soon stop the accumulation of a reserve fund to cover eventual losses. So when the losses actually occur, the taxpayers would be the ones to bear the costs.

Nor is the problem solved—as many of the supporters of these guarantee plans suggest—if the Government is liable for losses on guaranteed MBS only after the issuer of the MBS has absorbed the first losses and exhausted its capital. It is true that in this case issuers will have an incentive to be cautious about risk taking, but the Government guarantee eliminates an important element of market discipline—the risk aversion of investors. The existence of a Government guarantee will mean that no MBS buyer needs to be concerned about the quality of the underlying loans or the financial stability of the issuer. This is exactly analogous to the effect of deposit insurance on risk taking by banks. As is well known, deposit insurance permits bank depositors to ignore the risks a bank is taking—the principal reason that so many banks fail. As in the case of deposit insurance, Government backing of MBS will eliminate investor concerns about both the financial stability of the issuer and the quality of the mortgages underlying the MBS. The effect of this moral hazard is certainly one of the lessons of the GSEs' failure.

The GSE experience also shows how difficult it will be to limit the scope of any Government support program. The GSEs were seen as providing advantages to the middle class, mostly in the form of lower mortgage costs, and it was a natural impulse for Congress to want to extend those benefits to other constituents. The affordable housing goals were one example of such an extension, but so were the higher conforming loan limits, adopted in 2008, which allowed Fannie and Freddie to extend the benefits of their Government-backed low-cost financing to borrowers who were not at all low income or in any way economically disadvantaged. This is the way a legislature will work in a democracy, and there is no reason to assume that any limitations Congress might put on Government support of the mortgage market will continue for very long. Government-conferred benefits provide subsidies to certain favored groups, and Congress will always be attentive to extending these subsidies to others.

Where moral hazard is present, regulation is imposed to protect the Government and the taxpayers, and regulation of the issuers of the guaranteed MBS is another prescription of the advocates of Government guarantees. They argue that regulation will ensure that the issuers have sufficient capital to cover the risks they will be taking and thus to protect the Government and the taxpayers from loss. But experience with bank regulation has shown that regulation does not prevent excessive risk taking and does not ensure sufficient capital to cover risks. Its effect, indeed, is almost the opposite. By increasing moral hazard, it encourages risk-taking. Moreover, as shown by the recent experience of the FDIC, which (despite prompt corrective action) has suffered losses in the great majority of banks it has closed in the last 3 years, regulators are frequently unable to determine the financial condition of a regulated entity until it is too late. In these cases, the taxpayers will once again end up taking the losses.

Accordingly, the structure of most proposals for Government housing market guarantees will not provide any protection for the taxpayers. As with Fannie and Freddie and the S&Ls, when the losses come in the taxpayers will eventually have to pay the bill.

Nevertheless, the proponents of Government guarantees and their congressional supporters argue that there cannot be a functioning housing finance market without Government guarantees, and in the discussion below I show that these arguments have no merit.

Institutional Investors

One of the most frequently heard arguments in favor of Government guarantees is that institutional investors will only buy U.S. mortgages, or MBS based U.S. mortgages, if they are backed by the Government. On its face, this seems absurd, since in most advanced economies the housing finance market operates effectively without Government guarantees. Of course, if it were true that institutional investors will not buy MBS without a Government guarantee, it would be a weighty argument. However, it's a myth, disproved by the data, which shows that institutional investors are not major buyers of GSE securities.

According to the Federal Reserve's flow of funds data, nonbank institutional investors had assets of $28 trillion in the fourth quarter of 2010. About $13 trillion of this amount was invested in fixed-income or debt securities—but only $1.8 trillion was invested in U.S. Government-backed securities issued by Government agencies or by Fannie and Freddie. Thus, even at a time when private housing finance has not yet revived—and most of the investment in housing is flowing through Fannie and Freddie or the Federal Housing Administration (FHA)—less than one-seventh of the funds invested in debt securities by institutional investors were invested in Government-backed GSE mortgage securities.

Most likely, even these investments are only for liquidity purposes—made by money managers who want some small amount of Government securities that can be sold at any time in order to raise cash, no matter what the conditions in the market. These investors hold GSE securities because their yield is slightly higher than treasuries of equivalent maturity. As discussed above, it should be noted that by providing these investors with a security that carries a Government guarantee—an alternative to a Treasury security—Congress is raising the Treasury's interest costs, another cost levied on the taxpayers.

By contrast, at the end of 2010, nonbank institutional investors had assets consisting of $2.6 trillion in both residential and commercial whole mortgages. Whole mortgages are not guaranteed by Fannie and Freddie or the FHA. This means that even after the financial crisis, institutional investors held a larger dollar amount of mortgages that are not backed by the Government than the mortgages that are perceived as Government-guaranteed.

The Fed's flow of funds data also includes a $4.6 trillion category called "corporate and foreign bonds," which includes privately issued mortgage-backed securities. Although this category is not further broken down, the mortgage-backed securities within it would add to the total of mortgage assets not guaranteed by the Government.

This data should have a profound effect on the question of whether to replace Fannie and Freddie with another Government-backed system. They show that nonbank institutional investors are not investors in Government guaranteed debt (except for liquidity purposes) and prefer private mortgages and mortgage-backed securities to Government-backed instruments.

Who are these institutional investors, and why do they prefer whole mortgages and private mortgage-backed securities over U.S. Government-backed mortgage securities? The biggest members of this class fall into three categories—life insurers ($5.1 trillion in assets), private pension funds ($6 trillion) and mutual funds ($8 trillion). What these institutional investors have in common is a desire for yield. Life insurers and pension funds have long-term liabilities they have to cover, and mutual funds function in a competitive environment in which yield is important to retaining their investors. Privately issued instruments provide market rates of return that allow these institutions to meet their long-term obligations. U.S. Government agencies, by contrast, don't pass this test. Their yields are low because their interest rates, subsidized by the taxpayers, are lower.

That doesn't mean they have figured out how to escape from market risk. Instead, as we know from experience, the taxpayers eventually have to compensate for this risk through bailouts of Fannie and Freddie and other Government housing finance ventures. This analysis is confirmed by looking at who the buyers of Government-backed securities actually are. In 2006, before the financial crisis, 11 percent of the holders were foreign central banks, 23 percent were Federal, State, and local governments and enterprises and their pension funds, and 21 percent were insured depository institutions. Thus more than 50 percent of the demand for Fannie and Freddie mortgage-backed securities came from U.S. and foreign governments, or from organizations the Government controls or regulates. In other words, Government-backed mortgage securities are primarily attractive to risk-averse institutions or those with regulated capital requirements.

Thus, if we want U.S. and foreign institutional investors to invest in our mortgage market, we should be looking to a private system of mortgage finance, and not one run or backed by the Government. Private U.S. institutional investors have $13 trillion invested in fixed income or other debt securities. Much of this investment is going into corporate debt, including junk bonds, because mortgages or mortgage-backed securities yielding market rates are not available—and were not available even in 2006. If there were good private mortgage-backed securities available, institutional investors would be eagerly investing in the U.S. housing market.

Increase in Mortgage Rates

Another argument in favor of a Government-backed system is that the interest rates on mortgages will be lower than in a private system. There is little question that a Government backed housing finance system can deliver mortgages at lower rates than private systems, but that's because the Government is taking risks for which it will not be compensated. Instead, when the Government's losses show up, the taxpayers are handed the bill. If the taxpayers were not the ultimate insurer of the Government's risks, the rate on Government-backed mortgages would be the same as private mortgages, because the Government-backed loans would then reflect all the risks inherent in the structure. Those who support a Government-backed system must concede that it only provides lower rates because it puts the taxpayers at risk.

The 30-Year Fixed-Rate Mortgage

Many proponents of Government guarantees in housing finance argue that without a Government role in the housing market the 30-year fixed-rate mortgage will not be available to American homebuyers. On its face, this is not true, since anyone can go to the Internet and find lenders offering jumbo fixed-rate 30-year loans—which, by definition, have no Government backing. It is true that, at this point, a 30-year fixed-rate mortgage is somewhat more expensive than a Government-backed 30-year fixed-rate mortgage, but the lower cost of the Government mortgage simply means that the taxpayers are providing a subsidy to the person who wants a Government-backed mortgage with these terms.

Anyway, history has shown—and simple economics would anticipate—that a Government subsidy for a 30-year fixed-rate mortgage is not good policy. The subsidy causes most borrowers to choose the 30-year loan, since in general it offers a fixed, low monthly payment with a Government-subsidized "free" prepayment option. Supporters, including the Administration in its Option 3, point to the apparent stability it provides to borrowers. This "stability," however, carries with it several serious deficiencies. A 30-year loan amortizes slowly, keeping the homeowner's equity low and debt level high for a good portion of the loan period. In other words, it increases the homeowner's leverage. If the home is sold after 7 years (the average duration of occupancy), the homeowner has not accumulated much equity.[9] In addition, the "free" prepayment option encourages equity withdrawal through serial refinancing.

For these reasons, it is peculiar that the proponents of Government backing are never asked to explain why the taxpayers should be subsidizing a 30-year fixed-rate mortgage. This is not to say that this mortgage should not be available, but only that homeowners who want such a loan should not expect the taxpayers to subsidize its availability. In today's market, it is available at a slightly higher cost without a taxpayer subsidy.

The TBA market

Another frequently heard argument from the supporters of Government backing for residential mortgage finance is that only with Government backing can the To-Be-Announced (TBA) market exist. This is another myth. First, however, it is important to put the TBA issue in perspective. Just as commodity futures markets enable farmers to hedge the price risk of their commodities, the agency TBA forward market allows mortgage originators to mitigate their interest rate risk. Today, originators of both agency and nonagency mortgages use the agency market to hedge the risk of a change in interest rates between the time that a mortgage rate is "locked in" and the time the mortgage is actually closed and securitized. Reducing that risk has a positive effect on mortgage rates, but it is only one of the elements that go into the full cost of a mortgage. It would be dwarfed, for example, by a ¼ point increase in overall interest rates. The mortgage market could function effectively without a TBA market, but total mortgage costs—the principal component of which is the interest rate—would be slightly higher. Nevertheless, Government backing is not a requirement for the TBA market, just as it is not a requirement for a 30-year fixed-rate mortgage.

It is perfectly possible for a TBA market to develop for private MBS. This is because the TBA market function does not exist because of a Government guarantee but because of a high level of liquidity in the market—a large number of MBS that are regularly bought and sold. That liquidity is created by a convention—an agreement—among market participants about what they will accept as sufficient information about a particular pool of MBS. That convention, embodied in the *Uniform Practices for the Clearance and Settlement of Mortgage-Backed Securities*—adminis-

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[9] *See,* for example, Peter J. Wallison, "What's So Special About the 30-Year Mortgage?" *Wall Street Journal,* February 1, 2011, *www.aei.org/article/103092.*

tered by the Securities Industry Financial Markets Association (SIFMA) and otherwise known as the "Good Delivery Guidelines"—establishes that a seller and buyer in the TBA market need only agree on six factors to confirm a trade: issuer, maturity, coupon, price, par amount, and settlement date. [10] For example, as described in a recent paper by the Federal reserve Bank of New York, "a TBA contract agreed in July will be settled in August, for a security issued by Freddie Mac with a 30-year maturity, a 6 percent annual coupon, and a par amount of $200 million at a price of $102 per $100 of par amount, for a total price of $204 million." [11]

The limitation on the information available to the buyer makes the agency MBS, in effect, "fungible" with other agency MBS already outstanding and thus adds significantly to the liquidity in the market. As also explained in the Federal Reserve paper: "Paradoxically, the limits on information disclosure inherent in the TBA market actually increase this market's liquidity, by creating fungibility across securities, and reducing information acquisition costs for buyers of [agency] MBS." [12]

The existence of GSEs makes it easier for a TBA market to exist, because it removes credit risk as one of the risks that market participants must consider, but that is not essential for the TBA market to function. If the mortgages on which MBS are based are all relatively similar in quality—as they would be if certain minimum standards existed—that, combined with mortgage insurance, would create a private sector product not far off from an agency MBS. Then, all that would be necessary for a private TBA market would be a large number of MBS issuances and agreement on the same terms—issuer, maturity, coupon, price, par amount, and settlement date—as the current convention outlines for the agency TBA market.

Access to Capital in a Crisis

Finally, supporters of a Government-backed system argue that the Government's involvement will keep the market functioning in the event of another financial crisis. The Administration's February 11 report expresses concern about whether—in a fully private market—there will be sufficient access to mortgage credit during a crisis. The Administration notes, "absent sufficient Government support to mitigate a credit crisis, there would be greater risk of a more severe downturn, and thus the risk of greater cost to the taxpayer." [13] This idea gave rise to the Administration's Option 2, which is a private market with a Government backstop that would be invoked only in the event of a financial crisis that makes credit unavailable for housing.

However, if one assumes that some backstop is necessary, the Federal Reserve has already demonstrated that it can liquefy the housing market by purchasing MBS. The only question is whether the MBS are of good quality. If the underlying mortgages meet the quality tests outlined below, and include mortgage insurance, they would be of sufficient quality so that the Fed could purchase them without taking significant risks.

III. How a Private Market Would Be Structured

This testimony is not the place to describe in detail how a private MBS market would work. However, in March 2011, my AEI colleagues, Alex Pollock and Ed Pinto, and I issued a white paper [14] in which we responded to the Administration's February 11 statement and showed how Option 1 in that Administration report—which discussed a private market for MBS—would work. The white paper was based on four principles:

I. The housing finance market—like other U.S. industries and housing finance systems in most other developed countries—can and should principally function without any direct Government financial support

Under this principle, we note that the huge losses associated with the savings and loan (S&L) debacle of the 1980s and Fannie and Freddie today did not come about in spite of Government support for housing finance but because of that Government backing. Government involvement not only creates moral hazard but also sets in motion political pressures for increasingly risky lending such as "affordable loans" to constituent groups.

[10] James Vickrey and Joshua Wright, "TBA Trading and Liquidity in the Agency MBS Market", Federal Reserve Bank of New York Staff Reports, Staff report no. 468, August 2010, p. 7

[11] *Ibid.*

[12] *Id.*, p. 12

[13] Departments of Treasury and HUD, "Reforming America's Housing Finance Market", 28.

[14] Peter J. Wallison, Alex J. Pollock, and Edward J. Pinto, "Taking the Government Out of the Housing Finance: Principles for Reforming the Housing Finance Market", *AEI,* March 2011, *http://www.aei.org/paper/100206.*

Although many schemes for Government guarantees of housing finance in various forms have been circulating in Washington since last year, they are not fundamentally different from the policies that caused the failures of the past. The fundamental flaw in all these ideas is the notion that the Government can successfully establish an accurate risk-based price or other compensatory fee for its guarantees. Many examples show that this is beyond the capacity of Government and is in any case politically infeasible. The problem is not solved by limiting the Government's risks to MBS, as in some proposals. The Government's guarantee eliminates an essential element of market discipline—the risk aversion of investors—so the outcome will be the same: underwriting standards will deteriorate, regulation of issuers will fail, and taxpayers will take losses once again.

II. Ensuring mortgage quality, and fostering the accumulation of adequate capital behind housing risk, can create a robust housing investment market without a Government guarantee

This principle is based on the fact that high-quality mortgages are good investments and have a long history of minimal losses. Instead of relying on a Government guarantee to reassure investors in MBS, we should simply ensure that the mortgages originated and distributed are predominantly of prime quality. We know the characteristics of a prime mortgage, which are defined in the white paper. They do not have to be invented; they are well known from many decades of experience.

Experience has also shown that some regulation of credit quality can prevent the deterioration in underwriting standards, although in the last cycle regulation promoted lower credit standards. The natural human tendency to believe that good times will continue—and that "this time is different"—will continue to create price booms in housing, as in other assets. Housing bubbles in turn—by suppressing delinquencies and defaults—spawn subprime and other risky lending; investors see high yields and few defaults, while other market participants come to believe that housing prices will continue to rise, making good loans out of weak ones. Future bubbles and the losses suffered when they deflate can be minimized by interrupting this process—by focusing regulation on the maintenance of high credit quality.

III. All programs for assisting low-income families to become homeowners should be on-budget and should limit risks to both homeowners and taxpayers

The third principle recognizes that there is an important place for social policies that assist low-income families to become homeowners, but these policies must balance the interest in low-income lending against the risks to the borrowers and the interests of the taxpayers. In the past, "affordable housing" and similar policies have sought to produce certain outcomes—such as an increase in home ownership—which turned out to escalate the risks for both borrowers and taxpayers. The quality of the mortgages made in pursuance of social policies can be lower than prime quality—taxpayers may be willing to take risks to attain some social goods—but there must be quality and budgetary limits placed on riskier lending to keep taxpayer losses within known and reasonable bounds.

IV. Fannie Mae and Freddie Mac should be eliminated as Government-sponsored enterprises (GSEs) over time

Finally, Fannie and Freddie should be eliminated as GSEs and privatized—but gradually, so the private sector can take on more of the secondary market as the GSEs withdraw. The progressive withdrawal of the GSEs from the housing finance market should be accomplished in several ways, leading to the sunset of the GSE charters at the end of the transition. One way would be successive reductions in the GSEs' conforming loan limits by 20 percent of the previous year's limits each year. These reductions would apply to conforming loan limits for both regular and high-cost areas. This should be done according to a published schedule so the private sector can plan for the investment of the necessary capital and create the necessary operational capacity. The private mortgage market would include banks, S&Ls, insurance companies, pension funds, other portfolio lenders and investors, mortgage bankers, mortgage insurance (MI) companies, and private securitization. Congress should make sure that it facilitates opportunities for additional financing alternatives, such as covered bonds.

How a Private Market Will Attract Capital

The most important question for purposes of this testimony is how a private market would attract capital. I have already discussed the size of the institutional investor market, and shown that these investors are not attracted by Government-guaranteed MBS, except for liquidity purposes. Without any question, institutional investors will buy mortgages that have attractive risk-adjusted yields. However, if we want mortgage interest rates to remain low, we have to reduce the risks associated with these loans. In that case, institutional investors will not build in a large risk premium, which will add to mortgage costs.

One of the most effective ways to do this would be to specify certain minimum terms for all securitized mortgages. These would include a minimum downpayment of 10 percent, a borrower's FICO credit score of at least 660 and a borrower's debt to income ratio in the upper 30s. Even when these minimum criteria are specified, however, institutional investors will want assurance about the overall quality of the mortgages in the pool. One way to accomplish this is to create a contractual structure in which the top tiers do not take losses on the pool until the lower tiers are wiped out. This is the structure used in many securitizations before the financial crisis and in the securitizations that take place today.

In these offerings, the risk is mitigated by creating subordinated tranches (or tiers) that take the first losses. Only if the losses are greater than the size of those subordinate tranches will the top tiers (normally rated AA or AAA) suffer losses. This is an effective system, and could be attractive to institutional investors, but it has two problems: first, if the quality of the mortgages in the pool is poor, the subordinate tranches have to be thick (to absorb more expected losses) and this will raise interest rates on the mortgages in the pool; second, institutional investors do not have the facilities or capabilities to underwrite mortgage pools, and because of the failure of the rating agencies during the financial crisis institutional investors are now reluctant to rely on rating agencies for assurance about the quality of the mortgages in the pools. Therefore, another assurance mechanism is necessary.

The best and most efficient system for this is mortgage insurance. Under current state regulation of mortgage insurers, they are required to hold at least half of their revenues in a reserve fund for 10 years, an amount more than sufficient to deal with any foreseeable housing downturn. In addition, they have the facilities and ability to do the underwriting that institutional investors lack. It appears that if mortgage quality is controlled so that only prime mortgages are securitized, mortgage insurers can write insurance that covers losses down to a loan-to-value ratio of 60 percent without increases in mortgage costs that significantly exceed what Fannie and Freddie are now charging. A system that provides for a minimum set of mortgage standards, combined with mortgage insurance, could reduce the risk for institutional investor substantially. This would permit interest rates on the mortgages underlying the MBS to be competitive with any Government backed system where the taxpayers are not compelled to subsidize the risk.

A complete copy of the white paper, and its plan for a private housing finance market, may be found at *http://www.aei.org/paper/100206*.

This concludes my testimony.

PREPARED STATEMENT OF DWIGHT M. JAFFEE

BOOTH PROFESSOR OF BANKING, FINANCE, AND REAL ESTATE, UNIVERSITY OF CALIFORNIA

SEPTEMBER 13, 2011

Mr. Chairman and Members of the Committee, I welcome the opportunity to discuss with you today the future role of the Government in the U.S. mortgage market. There is now a widespread consensus that Fannie Mae and Freddie Mac—I will refer to them as the GSEs—should be closed as soon as practical. It is thus timely to consider the best means for replacing the mortgage market functions that have been carried out by the GSEs.

Current discussions focus on two primary alternatives for replacing the GSEs. The first alternative is to allow the private markets to replace the existing GSE functions, with the possible addition of expanding the FHA or a similar Government program with the goal to augment the supply of mortgage funding for lower-income borrowers and multifamily housing. The second alternative is to create a new Government program that will provide investors in conforming mortgages with an explicit Government guarantee against losses due to default.

My research leads me to a strong endorsement of the private markets as the preferred alternative for two reasons. First, there is strong evidence that the private markets are fully capable of carrying out all mortgage market functions to a standard substantially higher than actually experienced under the GSE regime. Second, experience indicates that a program of Government guarantees of conforming residential mortgages is highly likely to leave taxpayers, once again, to pay the high costs of defaulting mortgages. I will now briefly explain the basis for these conclusions.

I have recently carried out research that compares the mortgage and housing market performance of the U.S. with that of 15 major Western Europe countries. This is relevant because none of these European countries provides an amount of Government assistance to their housing and mortgage markets close to that provided in the U.S., and, in particular, none of them has any institution comparable to our GSEs. Nevertheless, the mortgage and housing markets of these countries have significantly outperformed the U.S. markets on all available measures.

The attached Table 1 provides the full data from my research. The first important fact is that the U.S. home ownership rate, 67.2 percent at year-end 2009, is exactly equal to the average rate of the 15 European countries, with the home ownership rates of 7 European countries actually exceeding that of the U.S. This is all the more remarkable because the population density of these countries far exceeds the U.S. and some of these countries—Austria and Germany for example—have long-standing social traditions to postpone the date of first home purchase.

Second, the average of U.S. mortgage interest rates has significantly exceeded the corresponding average for the 15 European the countries. The lower European mortgage rates are mainly the result of the much lower default rates for European mortgages. Even with the current financial distress in Europe, their mortgage default rates have remained very low. The financial distress currently facing many European banks is mainly the result of losses on construction loans and sovereign debt, and not from home mortgages.

I expect private markets will deliver lower mortgage rates in the U.S. for the same reason as in Europe. That is, private investors will require the mortgage loans they purchase to be originated under high underwriting standards. The decline in U.S. mortgage rates that will result from greater safety will offset the pressure toward higher mortgage rates that will result as the GSE subsidies are eliminated. Equally importantly, the switch to safer mortgages will preclude any future replay of the huge economic and social costs we are currently facing from high foreclosure rates on risky mortgages.

As to the second alternative, proponents of new Government guarantees for U.S. home mortgages often start by pointing out that the private mortgage markets are currently moribund, and that they see no mechanism through which the private markets can displace the current dominant role of the GSEs. In contrast, I believe the current dominant position of the GSEs is simply the result of crowding out, whereby any entity with a Government guarantee will always displace comparable private market activity. In my view, a private market revival will follow rapidly once we remove the current GSE subsidies.

I would also like to shed light on two further issues—I would say myths—raised by the proponents of expanded Government guarantees of residential mortgages. The first issue is their contention that the 30-year, fixed-rate, mortgage can exist only with a Government guarantee program. This is in error for two reasons. First, the primary risk on long-term, fixed-rate, mortgages is interest rate risk, and neither the GSEs nor the proposed Government guarantees provide any protection against this risk. Second, without even considering Government guarantees, the credit risk on long-term mortgages is actually lower than on, say, adjustable rate mortgages. The proof is that private markets in the U.S. and Europe have long provided long-term, fixed-rate, mortgages and at accessible interest rates.

The second issue raised by advocates of new Government guarantee is that the guarantees are essential to the continuing existing of the so-called TBA forward market for mortgage securitization. This is also in error for two reasons. First, as long as the existing FHA and GNMA programs exist, and most likely they will expand, the TBA market will continue to exist. Second, and more fundamentally, the private markets for hedging interest rate risk have proven highly satisfactory for controlling the pipeline risk that arises in private label securitization in the U.S. and covered bond issuance in Europe. I have to add that the arguments to protect the existing TBA market primarily reflect the wish of the vested interests in these markets to continue to earn fees from running the market, while transferring the risk of mortgage defaults to U.S. taxpayers.

I recognize, of course, that the U.S. housing and mortgage markets are currently in a highly distressed state, and rapidly closing down the GSEs would be inadvisable. There is, however, a very safe and dependable mechanism to close down the GSEs, namely to reduce the conforming loan limits in a steady sequence. For example, a reduction in the conforming loan limits by $100,000 annually would basically close down the GSEs in 7 years. This also has several additional desirable features:

- The GSE subsidies would remain on the smaller sized mortgages for as long as possible.

- The private market would anticipate the annual opening of each new tier of the market.
- The process could be stopped if it appeared the private markets were not responding.

A very important first step would be to allow the recent temporary increase in the conforming loan limits to expire as scheduled on October 1 of this year.

I also recognize that other researchers and market participants do not share my confidence in the private markets and they have proposed a variety of Government guarantee plans to replace the GSEs. The least intrusive of these plans proposes a temporary Government program of catastrophe insurance, to allow the markets more time to stabilize, before reverting to a fully private system. As it happens, catastrophe insurance is a second area of my research focus and I am therefore familiar with the successes and failures of the various Government insurance programs.

In my opinion, the Terrorism Risk Reinsurance Act (TRIA) is arguably the most successful of all the current Government insurance programs. As you may recall, TRIA provides reinsurance against the catastrophic losses that an insurer may suffer from providing terrorism insurance on commercial buildings. It was enacted, following 9/11, to provide insurers with the reinsurance that would allow them to provide building owners coverage against losses from a terrorist attack. TRIA has been successful in that the private market for terrorism insurance is now active and efficient, with private insurers taking the first-loss position for all events. Furthermore, taxpayer payments arise only for the most extreme events where the insured losses would substantially exceed the insured losses realized from 9/11. If a catastrophe back-stop for the U.S. mortgage market is considered critical, a TRIA-like plan could work well.

Unfortunately, I believe the actual plans for new Government mortgage guarantee programs are likely to require the U.S. Government itself to take the first-loss position, quite the opposite of providing reinsurance against only catastrophic losses. This is the experience with the National Flood Insurance Program on the Federal level and with the California Earthquake Authority and the Florida Hurricane Fund on the State level. While the authorizations for these programs all used the right words—no subsidies, risk-based premium, sound capital, *etc.*—in practice, they have all proven costly or ineffective. Specifically, you will recall that, following Katrina, the National Flood Insurance Program needed a $20 billion plus Federal appropriation to cover its losses. The Florida Hurricane fund is similarly a ward of the State of Florida. The California Earthquake Authority has had the good luck of no major earthquakes, but it also has reached remarkably few customers.

The common problem for these Government insurance programs is the inability to maintain premiums at a true actuarial level. Instead, inevitably, the underwriting standards and the premiums are reduced, sooner or later leading to taxpayer costs. I fear a new Government mortgage guarantee plan will follow this path, ultimately leading to further taxpayer losses.

Not to end on such a somber note, let me say again I believe that private markets can efficiently provide all the required mortgage market functions, and that steady reductions in the conforming loan limits is a safe and dependable means to make the transition.

Table 1: The Performance of European Mortgage Markets in Comparison with the US [1]						
Statistical Measures Computed with annual data by country for the years 1998 to 2009						
	(1)	(2)	(3)	(4)	(5)	(6)
	Rate of Owner Occupancy 2009	Coefficient of Covariation Housing Starts [2]	Standard Deviation of House Price Inflation	Mortgage Adjustable Rate Average Level	Mortgage Interest Rate Average Spread [3]	Mortgage To GDP Ratio 2009
Western Europe						
Austria	56.2%	6.8%	2.5%	5.00%	1.79%	26.2%
Belgium	78.0%	15.9%	4.1%	5.75%	2.54%	43.3%
Denmark	54.0%	57.4%	8.7%	5.90%	2.46%	103.8%
Finland	59.0%	14.4%	4.0%	4.34%	1.12%	58.0%
France	57.4%	18.2%	6.4%	4.90%	1.69%	38.0%
Germany	43.2%	29.5%	1.7%	5.19%	1.98%	47.6%
Ireland	74.5%	84.2%	13.8%	4.43%	1.07%	90.3%
Italy	80.0%	25.7%	3.1%	4.96%	1.63%	21.7%
Luxembourg	75.0%	19.2%	4.8%	4.26%	1.05%	42.0%
Netherlands	57.2%	12.3%	6.6%	5.13%	1.93%	105.6%
Norway	76.7%	24.3%	5.2%	6.28%	1.43%	70.8%
Portugal	76.0%	27.2%	4.1%	4.91%	1.64%	67.5%
Spain	85.0%	60.5%	7.7%	4.29%	1.03%	64.6%
Sweden	66.3%	61.7%	3.4%	3.83%	0.80%	82.0%
United Kingdom	69.5%	13.9%	7.1%	5.24%	0.75%	87.6%
EU Average	**67.2%**	**31.4%**	**5.6%**	**4.96%**	**1.53%**	**63.3%**
US	**67.2%**	**40.0%**	**7.5%**	**5.16%**	**2.10%**	**81.4%**
US Rank	**8th of 16**	**5th of 16**	**4th of 16**	**6th of 16**	**3rd of 16**	**5th of 16**

Notes:

(1) Unless noted otherwise, the data are all from European Mortgage Federation (2009), an annual fact book that contains comprehensive mortgage and housing market data for the years 1998 to 2009 for 15 Western European countries and the United States.

(2) Computation based on housing starts where available; all other countries use housing permits.

(3) The mortgage interest rate spread equals the mortgage interest rate (column 4) relative to the each country's 3-month Treasury Bill rate; Source OECD Economic Outlook Database.

PREPARED STATEMENT OF ADAM J. LEVITIN

PROFESSOR OF LAW, GEORGETOWN UNIVERSITY LAW CENTER

SEPTEMBER 13, 2011

Mr. Chairman, Ranking Member Shelby, Members of the Subcommittee:

My name is Adam Levitin, and I am a Professor of Law at the Georgetown University Law Center in Washington, DC, where I teach courses in structured finance, bankruptcy, and commercial law. I am also a member of the Mortgage Finance Working Group sponsored by the Center for American Progress, which has put forth a proposal for GSE reform. I am here today, however, as an academic who has written extensively on housing finance and am not testifying on behalf of the Mortgage Finance Working Group.

As an initial matter, I want to be clear where I stand ideologically on housing finance reform. In the ideal world, I would unequivocally prefer to see the U.S. housing finance system financed entirely with private capital. The Government's involvement in the U.S. housing finance system carries with it serious concerns of moral hazard and politicized underwriting.

I am nonetheless opposed to proposals to eliminate any Government guarantee from the housing finance system. My opposition is based on practical realities, not ideological grounds. It is important that we not allow our ideological predilections get in the way of common sense. Despite privatization's ideological appeal, there is a fundamental problem with privatization proposals for the housing finance system: they don't work. Indeed, fully private housing finance systems simply do not exist in the developed world.

Following the siren's song of privatization would put the entire U.S. economy in grave peril, as there is simply nowhere close to the sufficient private risk capital willing to assume credit risk on U.S. mortgages, even prime ones. The housing finance market is barely stabilized with massive Government life support; it is no longer on the operating table, but is in the financial equivalent of the intensive care unit. Pulling the plug on the Government guarantee will kill the housing market, not resurrect it. Eliminating the Government guarantee risks the flight of over $6 trillion dollars from the U.S. housing finance market—roughly half the dollars invested in U.S. mortgages. [1] Such an occurrence would be catastrophic for the U.S. economy.

Along these lines, I wish to make five major points in my testimony:

1. There is insufficient market demand for U.S. mortgage credit risk to support the U.S. housing market absent some form of Government guarantee.
2. The prime jumbo securitization market does not provide evidence of the viability of a large-scale private securitization market.
3. All five previous attempts at private mortgage securitization in the United States failed because of the inability of investors to manage credit risk in securitization.
4. There is no housing finance market anywhere in the developed world in which there is neither an explicit nor an implicit Government guarantee of at least catastrophic risk.
5. The choice we face is not guarantee versus no guarantee. It is between an implicit and an explicit guarantee. A Government guarantee is inevitable in the housing finance market, so it is best to make the guarantee explicit and well-structured and priced.

I. Lack of Market Demand for Mortgage Credit Risk

A mortgage carries two types of risks for investors: credit risk and interest rate risk. Credit risk is the risk that the borrower will default on the mortgage. Interest rate risk is the risk that interest rates will either rise—in which case the interest rate the investor earns on the mortgage will be below market—or that interest rates will fall—in which case the mortgage will now be at an above market rate, but with the borrower likely to refinance.

GSE and Ginnie Mae securitization divides the credit risk from the interest rate risk. Investors in Fannie, Freddie, and Ginnie mortgage-backed securities assume interest rate risk, but not credit risk. The credit risk is retained by Fannie, Freddie, or Ginnie, which often are insured for part or all of that risk, either through private mortgage insurers or through FHA insurance and VA guarantees.

In contrast with the GSEs and Ginnie Mae, investors in private-label mortgage-backed securities (PLS) assume both interest rate risk and credit risk. Over 90 per-

[1] Federal Reserve Statistical Release Z.1, Table. L.217, June 9, 2011.

cent of PLS were rated AAA at issuance by credit rating agencies. Investors who relied on these ratings understood the credit risk on these PLS to be negligible because of the quality of the underlying mortgages and various credit enhancements to the PLS, such as senior-subordinate credit structures, overcollateralization, excess spread accounts, and various types of insurance.

What this means is that the overwhelming majority of investors in the U.S. secondary mortgage market are not credit risk investors. Investors in Fannie, Freddie, and Ginnie MBS are not credit risk investors, and most investors in PLS did not perceive themselves as assuming credit risk. Instead, U.S. mortgage investors are interest rate risk investors.

Interest rate risk investors are very different types of investors than credit risk investors. Investing in credit risk successfully requires a different kind of diligence and expertise than interest rate risk investment. A large portion of the investment in U.S. mortgages is from by foreign investors. Chinese investment funds and Norwegian pension plans, for example, are unlikely to seek to assume credit risk on mortgages in a consumer credit market they do not know intimately. But interest rate risk is something that foreign investors are far better positioned to assume because it is highly correlated with expectations about U.S. Federal Reserve discount rates.

Proponents of secondary mortgage market privatization would have the Government guarantee completely eliminated, meaning that investors would bear both interest rate risk and credit risk.[2] There is no evidence that there is a substantial body of capital eager to assume credit risk on U.S. mortgages at any rate, much less at mortgage rates that would not be prohibitively expensive for borrowers. Even if PLS were structured to remove most credit risk from some securities, few investors are likely to trust credit ratings on MBS in the foreseeable future. What all of this means is that if the secondary mortgage market were completely privatized, as much as $6 trillion in housing finance investment—roughly half of the investment in the U.S. housing finance market—would leave the U.S. market. The result would be a collapse on a scale far worse than in 2008.

II. The Jumbo Market Does not Provide Evidence of the Viability of a Large Scale Private Market

Mortgages that are too large to qualify for purchase by the GSEs because of the statutory conforming loan limit are known as "jumbo" mortgages. There is a private securitization market in jumbo mortgages. In the jumbo market, investors assume both interest risk and credit risk. Advocates of privatization have suggested that the existence of the jumbo market is proof that a securitization market can function without a Government guarantee.

The existence of the private jumbo mortgage securitization market is does not demonstrate that there is sufficient private risk capital to support the entire U.S. housing market. The jumbo market is smaller and benefits from the existence of the Government supported market. The shape of the jumbo market in fact indicates that there is a quite limited demand of credit risk on U.S. mortgages, and certainly not enough to sustain the entire market absent a Government guarantee.

The jumbo market overall is substantially smaller than the conforming market. From 2001–2007, there were roughly two times as many dollars of conforming loans originated as jumbo loans, and in sheer origination dollars, the jumbo market has never comprised more than a quarter of the U.S. market.[3] Jumbo loans are more expensive than conforming loans; currently there is around a 60 basis point spread between jumbo and conforming rates, despite jumbos often being of higher credit quality. While some of that spread (which at times has been as small as 20 basis points) is a function of the GSE guarantee, it is also a reflection of limited demand for U.S. jumbo mortgages—meaning a limited demand for credit risk. If all U.S. mortgage investors were willing to assume credit risk, we should tighter credit spreads between prime jumbos and conventional conforming loans, and investors would be willing to assume the credit risk on jumbos for the additional return.

What's more, the securitization rate for jumbo loans is substantially lower, which has resulted in a much smaller amount of jumbo mortgage-backed securities issued than GSE MBS. (See Figures 1 and 2). Jumbos lower securitization rate is itself strong evidence of limited investor demand of credit risk on U.S. mortgages—at least at interest rates less than those borne on subprime loans.

[2] Notably some proponents of privatization would have a Government regulatory role in the market. It is hard to fathom the Government as regulating the market, but taking no responsibility then, if the market collapses.

[3] Inside Mortgage Finance, Mortgage Market Statistical Annual.

Figure 1. Securitization Rates for Conventional Conforming and Prime Jumbo Loans

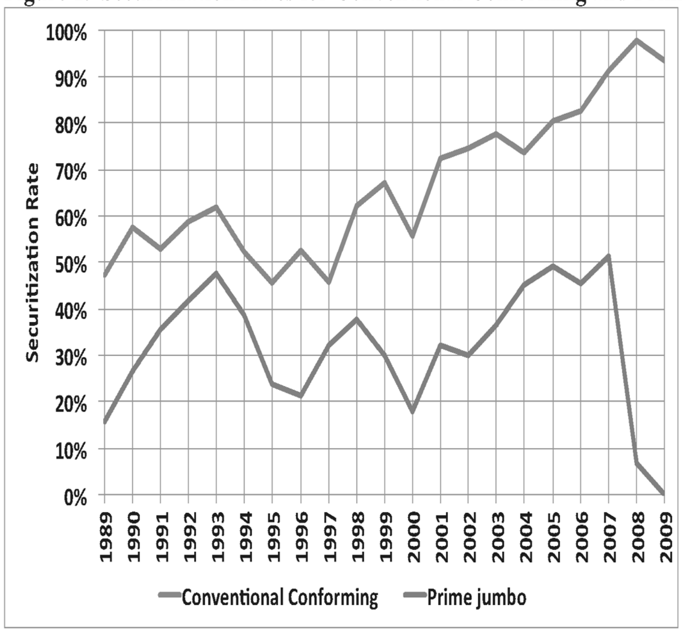
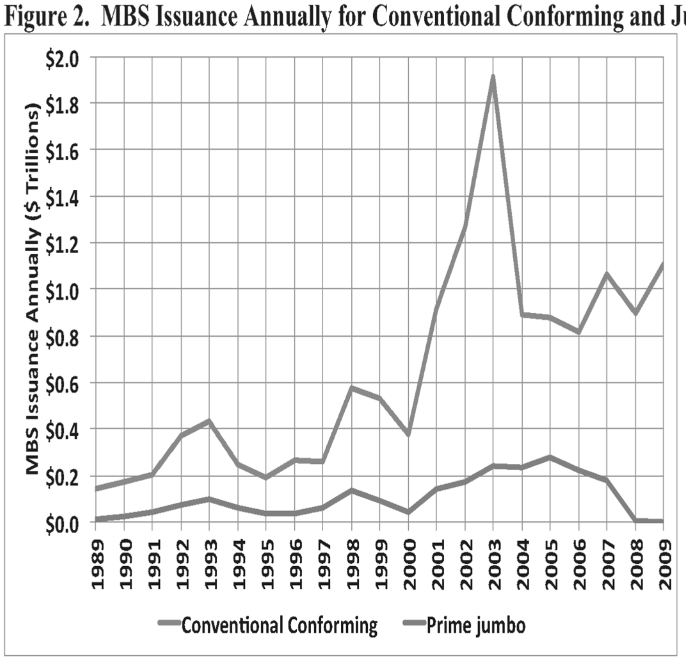


Figure 2. MBS Issuance Annually for Conventional Conforming and Jumbo Loans



Proponents of privatization also ignore that the jumbo market does benefit from a Government guarantee indirectly in multiple ways. The jumbo market has long aped the standards set by the GSEs in the conforming market, including amortization, maturity lengths, and appraisal standards. Indeed, the real benefit of the GSEs was not in terms of cost savings through efficiency or the Government guarantee but in standard setting; but for the GSEs, the 30-year fixed-rate mortgage would likely not exist. The standardization achieved by the conforming market has enabled the jumbo To Be Announced (TBA) market, which lets borrowers lock in their interest rates months before closing. The jumbo TBA market piggybacks on the existence of the highly liquid conforming TBA market. Whether this would continue absent a Government guaranteed TBA market is questionable.

Finally, the stability of housing prices in the jumbo market benefits from the Government guarantee in the conforming market. Housing prices of nearby properties are highly correlated. The ability for buyers or owners to obtain financing or refinancing significantly affects property values, so to the extent that the Government guarantee has stabilized the conforming market and thus bolstered the property values of properties with conforming mortgages, there is a spill-over that benefits properties with jumbo mortgages. The systemic stability that comes from the Government guarantee has benefited the jumbo market. Indeed, the virtual disappearance of the jumbo market following the financial collapse in 2008 draws into question whether this market is in fact viable; the spill-over benefits from the guarantee in the conforming market have not been enough to resuscitate the jumbo market.

The jumbo market demonstrates that there are some investors who are willing to assume credit risk on U.S. mortgages. But investors in the vast majority of the $6 trillion plus in U.S. mortgage securities outstanding are interest rate investors, and it is difficult to imagine them transforming into credit risk investors over several years, much less immediately. Sufficiently high yields will no doubt lure some of them into accepting credit risk-but that translates into much higher mortgage interest rates, which in turn increases the credit risk on the mortgages. And even higher yields will not be sufficient to induce investors who have no interest in assuming credit risk to buy into the U.S. mortgage market. The fundamental problem with any housing finance privatization proposal is that there just isn't sufficient capital interested in credit risk on U.S. mortgages. Ideology cannot substitute for market demand.

III. We've Tried This Five Times Before Without Success[4]

Privatization advocates pay little attention to the history of housing finance in the United States, but it holds a cautionary tale. The United States has had four previous experiences with private mortgage securitization. These experiences have been long-forgotten, but it is important to note that every time it ended in disaster, as did the fifth experiment, that of private label mortgage securitization in the 2000s. There is little reason to believe that a sixth charge of the Light Brigade will be more successful.

The U.S. did not develop a national secondary mortgage market until the New Deal. By the mid-nineteenth century, however, deep secondary mortgage markets were well-established in both France (the State-chartered joint-stock monopoly Crédit Foncier) and the German states (cooperative borrowers' associations called Landschaften and private joint-stock banks in Prussia and Bavaria), and "[b]y 1900 the French and German market for mortgage-backed securities was larger than the corporate bond market and comparable in size to markets for Government debt."[5] Although there were significant design differences in the European systems, they all operated on a basic principle-securities were issued by dedicated mortgage origination entities. Investors therefore assumed the credit risk of the origination entities. Because these entities' assets were primarily mortgages, the real credit risk assumed by the investors was that on the mortgages.

The European systems were successful because they ensured that investors perceived them as free of default risk. This was done through two mechanisms. First, there were close links between the mortgage origination entities and the state. Mortgage investors thus believed there to be an implicit state guarantee of payment on the securities they held. Second, and relatedly, the state required heavy regulation of the mortgage market entities, including underwriting standards,

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[4] This section of the testimony derives from Adam J. Levitin and Susan M. Wachter, "The Rise, Fall, and Return of the Public Option in Housing Finance", in *Regulatory Breakdown? The Crisis of Confidence in U.S. Regulation*, Cary Coglianese, ed. (University of Pennsylvania Press, forthcoming 2012).

[5] Kenneth A. Snowden, "Mortgage Securitization in the United States: Twentieth Century Developments in Historical Perspective", in *Anglo-American Financial Systems: Institutions and Markets in the Twentieth Century,* Michael D. Bordo and Richard Sylla, Eds. 261, 270 (1995).

overcollateralization of securities, capital requirements, dedicated sinking funds, auditing, and management qualifications.[6]

There were attempts to import the Crédit Foncier model to the U.S. in both the 1870s and 1880s. Mortgage companies that originated and serviced the loans, pledging them against "debentures . . . issued in series backed by specific mortgage pools."[7] These attempts failed as the originators often violated their stated underwriting standards and securitized only the lowest quality collateral.[8]

A third attempt at establishing a private secondary market was undertaken in the 1900s by New York title guarantee companies, which expanded beyond title insurance into mortgage and bond credit insurance.[9] The title companies originated mortgages, insured them, and then sold debt securities backed by the mortgages. The favored form were participation certificates that allocated the cash flow from the underlying mortgage pool in proportionate shares, much like later Fannie Mae/Freddie Mac Pass-Thru Certificates.[10] These participation certificates thus created a secondary market in mortgages. The purchasers of the participation certificates believed that they were assuming the credit risk of the title company that insured the mortgages, rather than the borrower, so they were not particularly concerned with the quality of the mortgage underwriting.

As defaults in the housing market rose in 1928–1934, the guaranteed participation certificate market collapsed. Poor regulation and malfeasance by the title companies made it impossible to weather a market downturn. The title companies were thinly capitalized and routinely violated their underwriting standards, and engaged in assorted other shenanigans that resonate of the excesses of the 2000s market.[11]

In addition to the guaranteed participation certificates, another type of secondary market instrument emerged in the 1920s, the single-property real estate bond. Whereas participation certificates were issued against a pool of mortgages, single-property real estate bonds were backed by a single building, a distinction roughly analogous to that between securitization and project finance. Single-property real estate bonds were used to finance large construction projects, such as the skyscrapers of New York and Chicago.[12] This system too collapsed in a series of scandals in the 1920s and '30s that made clear that underwriting standards had long been ignored. Their enduring legacy of the single-property real estate bonds is the Trust Indenture Act of 1939, the preamble to which is an indictment of the industry's practices.

Finally, in the 2000s we saw an explosive growth of private-label mortgage securitization. PLS great from 21 percent of MBS issuance in 2003 to 56 percent—a majority of the market—in 2006. PLS operated in a largely unregulated space and underwriting standards quickly collapsed. The growth in PLS ate away at the GSEs' market share, which encouraged the GSEs to be more aggressive in their underwriting. This competition between the GSEs and the unregulated PLS market proved fatal to the entire financial system.[13] Early American secondary mortgage markets share two critical commonalities with each other and with the PLS market in the 2000s. First, they were virtually unregulated, and what regulation existed was wholly inadequate to ensuring prudent operations. And second, they all suffered from an inability to maintain underwriting standards, as the loan originators had no capital at risk in the mortgages themselves, regulation was scant, and investors in the mortgage-backed bonds lacked the ability to monitor the origination process or the collateral. In contrast, successful European structures, "were either publicly financed or sponsored and were subject to intense regulatory scrutiny."[14] The historical evidence strongly indicates that both a Government guarantee and a robust, market-wide regulatory system is necessary to ensure a stable, liquid secondary market.

[6] *Id*. at 271–273
[7] *Id.* at 278.
[8] *Id.* at 279.
[9] James Graaskamp, "Development and Structure of Mortgage Loan Guarantee Insurance in the United States", 34 *J. Risk and Ins.* 47, 49 (1967).
[10] *Id.* at 49–50; Snowden, *supra* note 5, at 284.
[11] Graaskamp, *supra* note 9, at 51; Snowden, *supra* note 5, at 285.
[12] Snowden, *supra* note 5, at 286.
[13] Regarding the causes of the housing bubble and its collapse, *see,* Adam J. Levitin and Susan M. Wachter, "Explaining the Housing Bubble", 100 *Georgetown Law Journal* (forthcoming 2012), available at *http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1669401.*
[14] Snowden, *supra* note 5, at 263.

IV. All Developed Countries Implicitly or Explicitly Guarantee Their Housing Financed Systems

A truly private housing finance system is a pipedream. It simply does not exist in any developed country and never has. Every developed country either explicitly or implicitly guarantees some part of its housing finance system. In some countries, like Canada, the guarantee is explicit—and priced—and the market is regulated to protect the Government from excessive risk exposure. In other countries, the guarantee is implicit. It is difficult to prove an implicit guarantee; the very nature of it is that there is no clear proof. One can look at spreads between mortgage debt and Government debt, for example, but that is not necessarily conclusive. Indeed, in the United States, GSE debt was explicitly not guaranteed by the Federal Government . . . until it was.

Proponents of privatizing the housing finance system and eliminating the Government guarantee will generally point to Germany and Denmark as examples of housing finance systems without a guarantee that have widely available long-term, fixed-rate mortgages.[15] Unfortunately, this view of the German and Danish housing finance systems is incorrect. Germany and Denmark both turn out to have been latent implicit guarantee cases prior to October 2010, at which point they became examples of explicit guarantees.

In October 2008, Germany created a Teutonic TARP known as the "Special Fund Financial Market Stabilization," or SoFFin (its German acronym) to bail out its banks. SoFFin provided nearly €150 billion to support ten financial institutions' liabilities, including those of one issuer of covered mortgage bonds and of three Landesbanks (another type of German mortgage lender).[16] Germany was not prepared to allow even one of its numerous covered bond issuers to fail, even though any single issuer was arguably not a systemically important financial institution.

Denmark also announced a broad guarantee of all deposits and senior debt issued by its banks in October 2008.[17] Denmark has a robust mortgage lending system financed by covered bonds—bonds issued by banks against mortgage collateral held on balance sheet. Formally, the Danish guarantee did not apply covered bonds, only to the deposits and senior debts of the banks that issued them. The functional reality of this arrangement, however, was to guarantee the covered bonds by guaranteeing that the issuers would have sufficient assets and liquidity to meet their covered bond payment obligations so that the covered bondholders would never have to look to their cover pools of collateral for recovery.

There is no housing finance system in the developed world in which there is neither an implicit nor explicit guarantee, much less one which ensures the widespread availability of long-term, fixed-rate mortgages.

V. The Inevitability of a Guarantee Means It Should Be Explicit and Priced

The lack of a formal guarantee in good times is no guarantee against the application of a formal guarantee in bad times. Housing finance is simply too central to the economies of developed countries and to their social stability to permit market collapse. Put differently, there's no way to guarantee against a guarantee.

Therefore, it's better to accept that we are going to be living with a guarantee sooner or later—whenever the next crisis occurs—and to design a system that properly prices for it now. In 2008, the market saw that when threatened with collapse, the U.S. Government blinked. And despite Congress's best efforts and Dodd-Frank's no-bailout provisions (which still leave the door open for *sub rosa* bailouts), it's hard to believe that if threatened with massive economic collapse, the U.S. Government wouldn't bail out the financial system again. As distasteful as bailouts are, we as a society are simply too scared of the potential consequences of not bailing out the system to find out what would happen.

What this means is that if we are really serious about avoiding moral hazard, we actually have to have an explicit guarantee and price for it. Counterintuitively, an

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[15] *E.g.,* Peter J. Wallison, "A New Housing Finance System for the United States", Mercatus Center Working Paper No. 11-08, at *http://mercatus.org/sites/default/files/publication/wp1108-a-new-housing-finance-system-for-the-united-states__0.pdf,* at 10 ("Neither Denmark nor Germany backs any part of the mortgage financing system, which seems to work well because of the regulatory assurances of mortgage quality.").

[16] *See,* Bundesanstalt für Finanzdienstleistunsaufsicht, "Annual Report of the Federal Financial Supervisory Authority", (2008), available at *http://www.bafin.de/cln__152/nn__720486/SharedDocs/Downloads/EN/Service/Jahresberichte/2008/annualreport__08__complete,templateId=raw,property=publicationFile.pdf/annualreport__08__complete.pdf.*

[17] *See,* Neelie Kroes, "Guarantee Scheme for Banks in Denmark", European Commission Memorandum, State Aid NN51/2008—Denmark, available at *http://ec.europa.eu/community__law/state__aids/comp-2008/nn051-08.pdf.*

explicit and properly priced guarantee is the best protection against moral hazard. Otherwise, we will find ourselves in the next crisis with a private system that is suddenly guaranteed by the Government, and which has never had to pay for it, despite everyone in the market knowing that if things get really bad, Uncle Sam will come bail them out.

It is thus important to recognize, however, that the Government is not assuming more risk with an explicit guarantee. Instead, an explicit guarantee is just formalizing what the market assumes and hopefully pricing for it.

Conclusion

Try as we may, we cannot escape either history or the reality that the U.S. Government will always bail out its housing finance system if it gets into trouble. We did that in 1932–34. We did it with the S&Ls in the 1980s. We did it again in 2008. Catastrophic risk in housing finance is inevitably socialized, so it is best to recognized that truism and adapt our regulatory system to mitigate the risk. Pretending that it won't happen again is hardly a solution.

We do not have to like the existence of a Government guarantee in housing finance. But the choice we face is between an implicit and an explicit guarantee, not between a guarantee and no guarantee. All Government guarantees have clear problems—moral hazard because the Government holds the credit risk, while private parties hold the upside, and the danger of politicized underwriting. There are ways to try to guard against both problems. For example, moral hazard can be alleviated through use of deductibles and copayments—have first-loss private risk capital or loss splitting between the Government and private capital. Administrative structures can guard against politicized underwriting. Those risk mitigants, however, require an explicit guarantee.

For better or worse, though, we need to accept that some form of a Government guarantee, even if only for catastrophic losses, is required in our housing finance system. The unique nature of housing finance as an enormous asset class that affects a wide swath of citizens and economic and social stability means that no U.S. Government will permit the market's collapse: it would be economic and political suicide. The question then is not whether there should be a guarantee—we have one whether we want it or not—but how it should be structured.

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

PREPARED STATEMENT SUBMITTED BY THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION

SIFMA®
Securities Industry and
Financial Markets Association

July 20, 2010

RE: Public Input on Reform of the Housing Finance System

eDocket Number: TREAS–DO–2010–0001; eDocket Number: HUD–2010–0029

SIFMA[1] is pleased to submit this response to the Administration's request for comment on reform of the housing finance system. The financial reform legislation that has recently been passed by the Congress represents a comprehensive and critically important reformation of many aspects of the financial infrastructure of the United States. It will affect nearly all aspects of banking, capital markets, and consumer interaction with the financial system. One area it did not address, which is equally important, is the mortgage finance infrastructure of this country. While mortgage finance may seem to be a topic with a limited and defined scope, it is easy to underestimate the importance of mortgage finance and all of its ancillary aspects to the U.S. economy. Therefore, Treasury and HUD are right to move with all deliberate speed to address questions that linger around the future of this important part of the economy, and more specifically questions that surround the Government Sponsored Enterprises (GSEs) Fannie Mae and Freddie Mac. SIFMA believes that the process of discerning the appropriate way forward for these issues is an immensely complex process that cannot be rushed, but at the same time must be undertaken with the appropriate urgency and resolute determination to ensure that an appropriate conclusion is reached.

Executive Summary

There is no single "right answer" or any easy solution to the question of how to resolve the conservatorships of the GSEs and define the future infrastructure for mortgage finance in the U.S. Policymakers are faced with a series of difficult choices, each with its own costs and benefits, which will shape the future of housing finance. Ultimately, this essential infrastructure is both a creation of and a reaction to past public policy choices, and as such the future of it will grow out of further determinations of what is the appropriate public policy regarding mortgage finance. The request for comment is rightly very broad, and covers many aspects of housing finance. While there are many important questions, we believe a special and near-term focus needs to be placed on resolution of the current status of the GSEs. Therefore, the bulk of our response is focused on the multitude of issues connected to this topic.

In late 2009 SIFMA formed a GSE Reform Task Force[2] comprised of members of the Association involved in all aspects of mortgage lending, from originators to investors and the market makers that create liquidity between them, to discuss and develop shared views on what are the most critical aspects of GSE reform for secondary mortgage markets. The Task Force developed this response to share its

[1] The Securities Industry and Financial Markets Association (SIFMA) brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit www.sifma.org.

views with policymakers and others concerned about these issues. The discussion herein will address a number of issues and considerations that were determined to be significant by this Task Force and of particular interest to participants in the secondary markets for mortgage loans and mortgage backed securities (MBS). The paper does not propose any single comprehensive solution to the series of choices policymakers face; rather, it outlines a number of factors and considerations that should be used as inputs into the policy development process. A complementary goal of this document is to provide education and develop a base of knowledge about how these important markets operate. The work of the Task Force will continue, and delve into issues in more detail as specific areas of focus become clearer. Consequently, it is clear from the outset that the analytical and developmental process to be undertaken at the Department of the Treasury should be broadly inclusive explorations of the housing finance system, performed with depth and cross-sectional considerations, with adequate time and resources.

We note that it is generally clear what a path involving complete privatization of the mortgage finance industry would look like. Without the benefit of government support, mortgage credit would be less available and would be more expensive. Note that credit would be less available not only because lenders may not be able to support current volumes in a totally private market, but it would also be less available from the perspective of a consumer, because it would be less affordable. The exact impact in each of those areas, availability and cost cannot be determined with precision, as the impact is dependent on a number of economic and other factors, but at a high level, we do not doubt the directional impact of such a course of action. This is the first policy question that members of Congress and the Administration face: should the government provide material support mortgage lending?

A brief summary of the high level conclusions and considerations discussed in the paper follows:

- Secondary mortgage markets will continue to function regardless of what policymakers decide as 'there is a price for everything'. The price, however, is not always desirable to everyone. The issues for policymakers to consider are: how liquid secondary markets for loans and MBS would be, the breadth of products that would be offered to consumers, the capacity of lenders to extend credit, whether national lending markets could be sustained or if regional pricing differentials would reappear, and, ultimately, the cost and affordability of credit to consumers.

- Accordingly, policymakers need to determine what they want from the mortgage markets before they can address what to do with the GSEs or the broader infrastructure of mortgage finance.

- The GSEs, for all of their faults, have conferred significant benefits on U.S. mortgage markets. It is indisputable that these faults must be rectified and a new structure for the markets designed that will eliminate, or at least substantially mitigate, the source of these faults. We caution that the urge to "slay the dragon" should not cause collateral damage that would eliminate or make impossible the beneficial impacts and legacy of the old system that developed around the GSEs. One of the most important, if not the most important, was fostering the development of a liquid forward market for mortgage backed securities, known as the "to be announced" market or TBA, which allowed lenders to hedge risk, attracted private capital, and reduced the cost of mortgage lending. SIFMA's Task Force believes that this TBA market is the key to a successful, liquid, affordable, and national mortgage market, as well as ensuring a sufficient level of capital is available to banks to lend. The historically huge and liquid global market for GSE MBS is initiated by the TBA mechanism.

- Some form of an explicit government guarantee on MBS will be required to maintain the liquidity of the TBA MBS markets. Purely private sector solutions cannot accomplish this important goal.

- There are a number of permutations of a guarantee, but ultimately, a government insurance wrap of the MBS that stands behind any private sector insurance or other corporate guarantees, as a catastrophic backstop, may be the most efficient means to achieve this goal.

- In terms of whether or not a GSE is needed at all, how many are necessary, and other corporate structure issues, a number of options are available and could be implemented. There are policy choices to be made, and tradeoffs do exist. Regardless of what path is chosen, an eye must be kept toward preserving the simplicity and homogeneity of the GSE MBS markets in order to preserve the important liquidity provided by the TBA markets.

- Portfolios present a number of choices for policymakers. While they are necessary at some de minimis level for purely operational reasons (assuming GSEs or similar entities exist), moving beyond this operational level presents a number of challenges and choices for policymakers. If there is a goal to provide a mechanism to smooth out volatility of mortgage rates, portfolios are one way to accomplish this. Whether or not these roles are desirable on a risk vs. value basis and should be continued is a question for policymakers to decide.

- The resolution of the conservatorships of the current GSEs will clearly be a challenge. SIFMA task force members believe that the government must clearly state intentions with respect to legacy GSE issues prior to and during any transition. Bifurcation of markets into pre- and post-reform markets should be avoided. In this manner, supporting market and investor expectations through a continuity of the existing perception of a guarantee will engender future market stability and resulting investor participation. The alternative – essentially abandoning an existing market – would have serious and long term consequences for the global flow of capital to the United States.

We hope that the discussion that follows is useful and informative to the Administration as it considers this vitally important public policy issue. SIFMA stands ready to provide any needed information, support, and analysis during this process. Please do not hesitate to contact me or any of my staff with any questions or for more information.

Sincerely,

T. Timothy Ryan
President and CEO

Richard A. Dorfman
Managing Director, Head of Securitization

1. **How should federal housing finance objectives be prioritized in the context of the broader objectives of housing policy?**

   - ***Commentary could address: policy for sustainable homeownership; rental policy; balancing rental and ownership; how to account for regional differences; and affordability goals.***

One important point that should be made before a more detailed discussion of granular issues is that policymakers should determine how they envision the future of mortgage finance, and what goals they have for the U.S. mortgage markets before they delve into the specifics of various forms of corporate organization and other detailed issues related to the GSEs or any other aspect of the housing finance system. Drawing the lens back to a very high level, mortgage markets will continue to function, at some level, regardless of what policymakers decide – to repeat the common phrase, 'there is a price for everything', and markets will always find an equilibrium of supply and demand. The price and terms, however, are not always desirable to everyone. The issues for policymakers to consider are: how liquid the secondary markets for loans and MBS will be, the breadth of products that would be offered to consumers, whether or not 30 year mortgages could continue to be the primary term structure, the capacity of lenders to extend credit, whether national lending markets could be sustained or if regional pricing differences would reappear, and ultimately the cost and affordability of credit to consumers.

Before any other decisions can be seriously contemplated policymakers need to determine what they want from the mortgage markets. Considerations include: are national markets where the cost of a loan in Denton, Texas is similar to the cost of a loan in Portland, Maine desirable? Is there a policy basis for supporting and bolstering the liquidity of the mortgage markets and therefore reducing the cost of credit to consumers? Is the 30 year fixed-rate mortgage something that should be preserved? Is there a policy basis to support the securitization markets and the service they provide by facilitating the flow of capital from investors to homeowners? Should the government play a role in encouraging affordable rental housing funded by multifamily lending? Arguably, all of these things stem from, or have been historically bolstered by, Federal engagement in the mortgage finance system.

Our task force believes the answer to all of these questions is 'yes', and accordingly assumes these goals to be relevant. National mortgage markets should be maintained, and liquid secondary markets are necessary for them to exist. The broader economy is well served when mortgage rates are generally affordable to a large number of appropriately qualified consumers, given the important contribution of housing and all of its ancillary industries to GDP and employment. Therefore, our perspective is that some form of government support for mortgage markets should be provided, either through a GSE, GSE-like entity, government provided insurance, or some other means.

Our task force believes that an enhanced support system for enhanced rental credit underwriting standards looks back to the fundamental precept that individual ownership of housing, while an elemental social goal, cannot prudently be available to all citizens. In fact, the social goal should be quality housing shelter, whether ownership or rental, appropriately balanced with financial prudence. In this context, rental housing has a major role in the future and presumably a bigger role than it has today.

Affordable housing is a policy goal and we do not comment on whether or not it is an appropriate policy goal. However we believe that any implementation should be expressed transparently. Further, the implementation of affordable housing programs should be accomplished independently of the securitization process, and not buried within securitization structures and processes. Doing so will create distortions and lead to outcomes that are overall less efficient, and at worst, potentially harmful,

2. What role should the federal government play in supporting a stable, well-functioning housing finance system and what risks, if any, should the federal government bear in meeting its housing finance objectives?

- ***Commentary could address: level of government involvement and type of support provided; role of government agencies; role of private vs. public capital; role of any explicit government guarantees; role of direct subsidies and other fiscal support and mechanisms to convey such support; monitoring and management of risks including how to balance the retention and distribution of risk; incentives to encourage appropriate alignment of risk bearing in the private sector; mechanisms for dealing with episodes of market stress; and how to promote market discipline.***

Role of the Federal Government in Housing

Task force members have concluded that some form of explicit government support is needed to attract sufficient investment capital to maintain liquidity and stability in the conventional mortgage market at a level comparable to that created over the last 30 years. Members believe that total privatization of the GSEs and mortgage finance will likely result in greater volatility, increase inefficiency, and ultimately make mortgage loans more expensive for consumers. While this document generally does not address issues of pure public policy, as these are decisions to be made by members of Congress, Task Force members do believe that there should be a role for the government in promoting liquid mortgage markets.

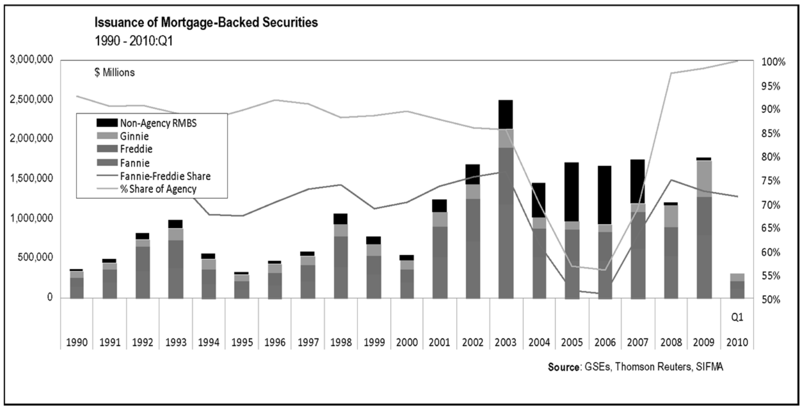
To promote liquid mortgage markets, Task Force members agree that any future form of the GSEs (or other government support) will require some form of an explicit government guarantee on certain MBS issuances. Our Task Force members do not believe that investors will support a return to an implicit guarantee, and also agree that a GSE or successor MBS program without a guarantee (i.e. an explicit non-guarantee) will not allow the GSEs or successor entities to meet any policy objectives. We note that loan level guarantees are not necessary if the security carries a guarantee. This need for an explicit guarantee after the conservatorship concludes applies to both future MBS issuances and currently outstanding MBS and corporate debt.

It is important to note that the GSEs, setting aside their current situation and flaws, were important contributors to many benefits to homeowners and the economy. It can be argued that a 30 year, fixed rate mortgage would not be considered the “standard” mortgage product today but for the GSEs. The GSEs have also driven a great deal of standardization of mortgage loan documentation and other operational processes that make mortgage lending more efficient and cost-effective. Most importantly, the GSEs have fostered, in conjunction with industry participants, the To-Be-Announced (TBA) secondary market for mortgage-backed securities (MBS). This market developed out of the standardization of mortgage products and securitization driven by the GSEs. SIFMA’s Task Force believes that this TBA market is the key to a successful, liquid, affordable, and national mortgage market, as well as ensuring a sufficient level of capital is available to banks to lend.

The Conventional Mortgage Market and the Historically Important Role of the Government

Fannie Mae and Freddie Mac alone support approximately 60% of all originations nationally. In the aftermath of the credit crisis, Fannie Mae, Freddie Mac, and Ginnie Mae through their MBS issuances and/or guarantees support over 90% of mortgage originations. At the end of 2009, approximately $5.5 trillion of GSE and Ginnie Mae MBS was outstanding, supporting half of all outstanding first-lien mortgage debt (the other half is retained on bank portfolios or is funded in the non-agency MBS market). Figure 1 (below) illustrates the heightened importance of Federal engagement in mortgage finance. For context, there were about $7 trillion of U.S. Treasury securities outstanding at the same time. These numbers are meant to illustrate the importance, both historically and especially currently, the sheer size and the significance of the conventional and FHA/GNMA mortgage markets. There is one common feature among the FHA/GNMA and GSE programs – government support. This support has provided much benefit to American homeowners – it has expanded the availability of credit, reduced costs through standardization and driven economies of scale.

Figure 1 – Issuance of MBS



It is indisputable that the faults of the current system that are now painfully evident must be rectified, and a new structure for the markets designed that will eliminate, or at least substantially mitigate, the source of these faults. We caution, however, that the urge to "slay the dragon" should not cause collateral damage that would reverse, or make impossible to sustain, the beneficial impacts and legacy of the old system that developed around the GSEs. It is important to note that GSEs have conferred benefits beyond the conventional market. Standardization, discussed below, is one such example. We also note that GSE MBS markets serve as benchmarks and signals to non-GSE markets in terms of pricing. Additionally. a GSE-related concept, that of a "qualified mortgage" as delineated in the recent financial regulatory reform legislation (H.R. 4173, the Dodd-Frank Act), represents in some ways the exportation of GSE-like underwriting criteria to the broader mortgage markets. In other words, the GSE markets serve as both a model and a point of reference for all mortgage markets. Clearly, what was once akin to a gold standard has become significantly tarnished, but that does not mean it needs to be destroyed in its entirety.

Standardization has been a key benefit of the GSE model in the conventional market. Due to their size and the scale of their operations, the GSEs have driven standardization of mortgage loan documentation, underwriting, and other items in ways that have created a more efficient origination process. This standardization extends beyond the Agency market, and has driven standardization of lending processes more generally, across product types, and across institutions.

Perhaps more importantly, government engagement combined with the activities of the GSEs have driven the standardization of loan maturities out to 30 years, creating a mortgage product that is affordable to a greater proportion of consumers. Most people take for granted that typical mortgage loans have a 30 year term, but given the nature of bank funding, this is not a natural outcome. Before the implementation of government programs such as the Homeowners Loan Corporation, FHA, and Fannie Mae in the 1930s, mortgages tended to be short term and require a balloon payment at the end of the term. This was directly related to the short-term nature of bank funding; many institutions derive a majority of funding for lending from customer deposits which are redeemable upon demand. The development of secondary markets for loans and MBS through government initiatives allowed banks to extend loans with longer terms, as banks were able to access a longer-term funding source (in addition to transferring risk, reducing balance sheet utilization, and reducing demands upon limited capital) in the form of loan sales into active secondary markets and ultimately securitization. Without the initiatives undertaken by the government in the 1930s and the continuing support of the GSEs, it is not clear that today's mortgage loan would have a 30 year term.

Benefits of a Guarantee – Liquidity, Stability, and Lower Mortgage Rates through the Attraction of Substantial Domestic and International Investment Capital Flows

The implicit guarantee on GSE MBS historically reduced the issuance costs for those bonds because it attracted a number of important classes of investors and provided for the development of a large, extremely liquid secondary market. These investors include pension funds, mutual funds, bank portfolios, insurance companies, and significantly, foreign central banks and other substantial foreign investors. Non-U.S. institutions hold hundreds of billions of dollars of GSE MBS – this represents hundreds of billions of dollars that have been channeled into the hands of U.S. homeowners – and along with banks and the GSEs themselves, foreign investors have been one of the largest buyers of these securities. Many of these institutions are extremely sensitive to credit risk, and it can be argued that an important part of the rationale for the entry of the GSEs into conservatorship in 2008 was to assuage the concerns of investors that an element of credit risk had been introduced into a market that depends on the absence of such risk. Prior to the conservatorship, the GSEs began to experience greater difficulty issuing corporate debt, and spreads on MBS products began to widen, in part due to a reduction in foreign investment. Task force members agree that in the future these investors will not accept an implicit or non-guaranteed MBS product.

These institutions are attracted to the GSE MBS markets for a variety of reasons, but chief among them are the safety of the investments and the liquidity that the market provides. We earlier detailed the scale of the GSE MBS markets; when this scale is combined with the homogeneity of collateral that backs the securities and securities themselves, the result is a market where investors are able to invest significant sums of money in a timely fashion without creating undue distortions to prices. GSE MBS has become an essential component of many investment fund mandates. For example, many investors benchmark their funds against various indices. In one commonly referenced index, the Barclay's U.S. Aggregate Index, MBS represent over 1/3 of the index. GSE MBS provide a safe, liquid investment product for many 401k plans, pension plans, and insurance companies. Without this asset class, these investors would struggle to replicate the combination of liquidity and return, and would either move towards lower yielding products such as Treasuries, or into riskier products such as corporate or other sovereign debt. Such shifts in asset allocation would not only reduce the flow of capital to mortgage markets, but it would also have a negative impact on the performance of those investment vehicles.

This liquid market would not have been possible without the implicit guarantee on the debt. It is notable that no other mortgage market or funding system via depositories has ever provided sustained liquidity to the extent that the GSE MBS markets have. It is also notable that each secondary mortgage market that was not the beneficiary of a guarantee collapsed in 2008. The GSE MBS markets are considered "rates" markets, as opposed to "credit" markets, similar to the Treasury market. Investors in these markets do not need to, and do not want to, engage in detailed loan-level credit analyses of the securities they are investing in. Rather, investors look to take positions based on their views of interest rates (and resulting payment speeds of the underlying borrowers) and other macro- and microeconomic factors that drive borrower behavior. Furthermore, many investors in GSE MBS are only investors in these products due to the implicit guarantee. If the guarantee is removed, they will no longer participate in these markets, in some cases regardless of the yields offered on the securities.

SIFMA's Task Force does acknowledge, however, that a substantially larger, government supported mortgage market could potentially impact the Federal Reserve's management the general levels of pricing of credit in the economy, because the supply of credit could be managed through changes to underwriting standards for loans eligible to be insured, which in some cases could act in an opposing direction to changes in general levels of interest rates. The extent of this impact, and its relative significance compared to the benefits such a regime would confer on consumers, are unclear, and ultimately determining these answers is best left to policymakers. It is another factor that should be included in the consideration of the future of the U.S. mortgage finance system.

The Importance of the TBA MBS Markets Cannot Be Overstated

The majority of trading volume in the agency MBS markets today is in the form of "To-Be-Announced" (TBA) trading. For background, a 'TBA' is a contract for the purchase or sale of agency mortgage-backed securities to be delivered at a future agreed-upon date; however, the actual pool identities or the number of pools that will be delivered to fulfill the trade obligation or terms of the contract are unknown at the time of the trade. Actual mortgage pools guaranteed by one of the Agencies are subsequently "allocated" to the TBA transactions to be delivered upon settlement. Settlement dates of transactions are standardized by product type (e.g. 30 year FNMA/Freddie Mac pools, 30 year Ginnie Mae pools, 15-year pools) to occur on four specific days each month. Monthly settlement date calendars for the TBA market are published one year in advance by a SIFMA committee on a rolling 12-month basis. This is done to increase the efficiency of the settlement infrastructure, and facilitate forward trading. Most trades are executed for settlement within one to three months, although some trading may go further forward from time to time.

For example, Investor A would call up Market Maker A on July 1, and order $10 million FNMA 5.5% coupon 30-year MBS, for settlement on August 15. The investor does not specify specific bonds or CUSIP numbers. On August 13, according to market practice, Market Maker A would notify Investor A of the specific identities of the pools that will be delivered on August 15. Most likely, these will be MBS that were just issued at the beginning of August.

Similarly, and importantly, a loan originator can enter into forward TBA sale contracts, allowing them to hedge the risk of their loan origination pipelines. This permits the lenders to lock in a price for the mortgages they are in the process of originating, benefitting the borrower with the ability to lock in mortgage rates earlier in the process. Pricing on loans varies from day to day with fluctuations in the TBA markets, and lenders will often re-price loans for their bankers and correspondent partners on a daily basis. Thus mortgage bankers follow the market in order make decisions on when to lock in a rate for a borrower.

There are currently over $3 trillion in bonds eligible for TBA trading – it is a vast market. It is also extremely liquid – Federal Reserve data shows average daily trading volumes of Agency MBS reported by the Fed's primary dealers as exceeding $300 billion *per day* over each of the last 3 years. Private estimates of daily TBA trading volumes exceed $600 billion (these estimates take in to account trading beyond that of the primary dealers). Liquidity in this market is second only to the market for Treasuries. This liquidity allows investors to buy and sell significant quantities of securities quickly and without disrupting the market. This makes the market very attractive to these investors who have substantial funds to be invested.

As mentioned above, the TBA market is the most liquid, and consequently most important, secondary market for mortgage securities. In this time of distress, the importance of the TBA market is heightened, and it is difficult to exaggerate the consequences from a loss of confidence or liquidity in this market. The effects would be directly and immediately felt by the average mortgage borrower. The impact would include, at a minimum, higher mortgage rates, as yields required by investors would rise as liquidity falls. It is also likely that credit availability would be constricted. This would occur because secondary market executions for originators would be more expensive and take longer, requiring longer warehousing periods for loans they originate. Balance sheet capacity is a currently a scare commodity for most lenders, and is finite in any case. Furthermore, the ability of borrowers to lock-in rates on mortgage applications would likely be reduced, creating uncertainty for them and likely depressing real estate activity which is an important component of broader economic activity.

Ultimately the decision to guarantee or to not guarantee is policy choice for Congress. However, our view is that the choice presented is not one of degrees, but is more akin to a binary choice – the result will either be large, efficient, liquid, national conforming mortgage markets, or it won't be. Task force members believe a liquid TBA market is a required and essential component of the mortgage finance system, currently and in the future, with an importance that cannot be underestimated.

Purely Private Sector Insurance Solutions Will Not Provide Needed Support and Confidence to Support TBA Trading of MBS

Some have suggested various models of private market insurance for future MBS issuances. Our members do not believe these private sector models will attract the necessary investor capital and will not foster the maintenance of extremely liquid markets that a government guarantee will provide, and cannot support markets where securities trade TBA. One reason is that private sector mono-line insurance companies have not fared well in recent times of market stress – and in the most recent crisis this applies to both mortgage insurance companies as well as bond insurers. Many insurers have ceased underwriting new business, have entered a wind-down mode, and/or have ceased paying claims on their insurance policies. Clearly private sector solutions were not, and likely will not be, resilient in times of stress. In any case, it is doubtful that investors will believe them to be, which is the most critical consideration. Given the size of the U.S. mortgage markets, any comprehensive private insurance system would have to be so large, and would require so much capital to withstand the proverbial 100 year storm, that it is hard to see how it could be done in a manner that would provide anything approaching equality in terms of cost, efficiency, stability, or resilience to that provided by the GSEs today, unless the private insurance entities are ultimately backed by the government. If they are backed by the government, it is more efficient and less costly for the government to provide the insurance itself directly to the MBS. Private insurance would introduce an element of credit risk into the analysis of the MBS, which as discussed above would immediately eliminate certain classes of investors and would significantly impair the flows of capital to mortgage markets, resulting in higher rates for mortgage borrowers.

The Explicit Guarantee Can Take A Number Of Forms, But Government Re-Insurance May Be Most Efficient

There are a number of ways that an explicit guarantee on GSE MBS could be structured. The bottom line for a guarantee is that investors must know that they will receive back at least their invested principal.

Currently, both GNMA and GSE MBS also guarantee that investors will receive the scheduled interest payments on a given loan, so long as the loan is outstanding. This means that at times, the GSE or the servicer, depending on the program, must make up what is referred to as a prepayment interest shortfall. For example, a loan might pay off on the 15th of a month, but interest is due to the bondholders for the entire month – the lender, servicer, or sometimes the GSE will make up that shortfall. Some have suggested that the guarantee of payment of all scheduled interest be eliminated as a way to decrease the cost of a guarantee. However it will introduce more volatility into the analysis of prepayments and possibly result in investors demanding higher yields to compensate. Therefore, the optimal outcome for mortgage borrowers, in terms of rates, would require the guarantee of payment of these interest shortfall amounts.

One option is a full faith and credit guarantee where the government backs the timely payment of principal and interest on the entire security, similar to the guarantee on GNMA securities. It is important to note that in the GNMA context, the loans that underlie the securities are also guaranteed, by the Federal Housing Administration. This underlying guarantee is not required, however, in the context of GSE discussions. This type of security-level guarantee would provide the necessary comfort to investors that they will see the return of their invested principal. However, this is likely the most expensive form of a guarantee from an accounting perspective, as the government is essentially responsible for a guarantee of each dollar of loss on a bond. This may be appropriate in the context of GNMA, but is probably not in the context of a regime where an entity stands between the government guarantee and investors, with the ability to provide its own corporate guarantee.

Government Reinsurance

Thus another logical, and possibly preferable, structure for a guarantee would have the government re-insure a corporate guarantee on the MBS. The MBS issuer (presumably a GSE) would take on the "first loss" position, and the government guarantee would only be triggered in the event that the issuing entity was unable to stand behind its corporate guarantee. The issuing entity would pay a fee for the use of this government guarantee, which would be determined by the government and could be adjusted based on risk, changing market conditions, or other policy considerations that we do not address here. In benign environments, this guarantee fee would be a source of revenue for the government. In stressed environments, the government may or may not have to pay out on claims; this would depend on the capitalization of the issuing entities and the severity of the market distress. A guarantee of this nature would appear to fulfill dual mandates of comforting investors and ensuring stability in mortgage markets, and minimizing the (real and accounting) costs to the government. We do not believe, however, that this government reinsurance can be pegged at any specific level (e.g., government reinsurance only covers 30% of the face value of the bond and the issuing entity is responsible for the other 70%), as this would introduce credit risk into investment considerations and likely result in tiering of the market if there is more than one issuing entity.

We do note that reinsurance programs of a corporate first-loss guarantee would present certain challenges. In a first loss position, the successor entities (and possibly their regulator, depending on the future framework) would be powerful gatekeepers at key policy points in the housing cycle through their management of levels of guarantee fees. Past experience shows that the GSEs were at times reluctant to make major changes in their guarantee fees, possibly due to a concern that they could be construed as regulating the flow of credit. We note that OFHEO was studying whether g-fees were too high in 2007 due to historically low loss experiences. Providing a future private (or semi-private) enterprise (cooperative or otherwise) with this sort of systemic power will present these same issues, and policymakers should be conscious of them.

Secondly, it may be difficult or impossible to empirically determine the appropriate level of first loss cushion. The likely error will be to the high side, over capitalizing/reserving any new entities. The result of this for homeowners would be higher costs than are truly necessary. On the other hand, if an option is presented to somewhat over- or under-capitalize such an institution, it may be prudent and more politically palatable to err on the side of over-capitalization.

Should the GSEs have Private Ownership?

At this point SIFMA's task force has not focused on specific permutations of corporate structure for the future GSEs or their successor entities, the levels of capital required for each, and the sources and cost of that capital. At a high level, however, SIFMA members do not believe that some form of private ownership interest in the future GSEs is an unreasonable or unwise outcome on its face. However, as mentioned previously, our focus has been on secondary markets and what is required to preserve the liquidity and other benefits the current regime has conferred upon mortgage markets. Our task force members do agree on one high level concept, however: if some form of a GSE exists in the future, it should be established with a limited and specific charter that outlines a limited and specific mission, along with a strong regulator empowered to regulate and manage the activities of the entity in all appropriate ways, but acts in coordination with entities such as the Treasury and Federal Reserve to ensure the safety and soundness of the broader financial system. Changes to this charter and mission should be solely within the purview of Congress.

Can Private Banks, Either Individually or as Consortiums, Replace the GSEs?

If the government is willing to provide reinsurance for a fee, one can argue that GSEs are not needed; rather, that banks could issue their own government reinsured MBS off their own shelves. This presents a number of challenges that would need to be considered to ensure that liquidity and efficiency are preserved. For one, such a system may favor larger lenders over smaller ones, as small lenders could have problems warehousing loans until they reach critical mass that would support an MBS issuance. It could also result in smaller lenders being forced to maintain a relationship with a large bank which would serve as an aggregator, which is a role that was previously filled by the GSEs through their cash windows. Given recent accounting rule changes (SFAS 166 and 167), it is also unclear if banks that issued their own MBS would be able to move the assets off their balance sheet to free up regulatory capital that would support further lending. The outcome would depend on the facts and circumstances surrounding the MBS programs. Currently, the GSEs consolidate MBS on their balance sheets, allowing lenders to recycle scarce capital into new loans, ultimately reducing mortgage rates and increasing credit availability. This is an important consideration for any future system.

A reinsurance model would also support an approach whereby cooperatives would be formed and owned by their member banks, with a special charter, akin to the Federal Home Loan Bank system (but with a different purpose). This approach could avoid some of the challenges discussed above.

What is clear from our discussions is a view that a completely privatized system, with no GSEs and no government guarantee, will not be able to support liquid secondary markets for MBS, and will result in significantly increased borrowing costs and significantly lower lending capacity and credit availability. These costs would be even more significant during times of economic distress. That being said, policymakers must determine the appropriate public policy goal with respect to mortgage finance and government subsidies to promote greater availability of mortgage credit. There are a number of options between purely private and purely public alternatives that can be considered each with its own costs and benefits, which may differ depending on one's perspective.

Alignment of Interests

SIFMA agrees that a general alignment of interests of securitization transaction participants is important, at a high level. In other words, originators, issuers, sponsors, and cash investors should share an interest in transactions where material terms and risks are properly disclosed, and absent external factors, the assets perform in line with expectations. There are a number of methods through which the incentives of participants may be aligned. Chief among these, especially in the context of GSE-issued MBS, are repurchase rules. Sellers of loans to a securitization are generally contractually obligated to repurchase loans that violate a representation and warranty made at the time of the transfer of the loans. The GSEs have proven especially effective at enforcing these contractual risk retention obligations. Outside of the GSE markets, a number of originators have suffered significant losses, or even gone out of business entirely, because of repurchase requirements based on representation and warranty violations.

The process of working through these contractual claims is not always easy outside of the GSE MBS markets where the GSEs have significant ability to compel repurchases; therefore other measures of risk alignment have been advocated such as the retention of economic interests by sponsors of securitizations. Generally, SIFMA supports requirements such as those in the Dodd-Frank Act for transaction sponsors to retain a meaningful economic interest in securitized products, with appropriate regulatory discretion in terms of implementation of such a regime. We believe that retention of such an interest can help to align the incentives of originators and sponsors with securitization investors, thereby helping to restore confidence and functionality to the securitization markets, an essential step in the path to economic recovery and growth. SIFMA believes it is very important that Federal regulators are given the authority to design and apply retention requirements in a manner that specifies permissible forms and amounts of retention, how retention requirements may be calculated and measured, the duration of retention requirements, whether and to what extent hedging of retained interests is permissible, and other important implementation details. We note that as providers of a corporate guarantee of principal and interest on securities, the GSEs retain 100% of the risk of their issuances.

Many also point to alternative structures such as covered bonds, where loans remain on the issuing bank's balance sheet. Covered bonds are often discussed as a replacement for, or an alternative to securitization. SIFMA and its members strongly support the development of a covered bond market in the U.S., and in 2008 SIFMA formed the U.S. Covered Bond Council, which comprises issuers, market makers, and investors in covered bond markets to further this mission. One of the primary goals of this group is to establish a legislative framework for covered bonds in the U.S., as this is viewed as an essential component of the growth of this market. SIFMA members do not believe, however, that covered bonds should be viewed as a replacement for securitization or the GSEs, especially at this point in time. SIFMA members encourage policymakers to promote and foster a liquid covered bond market, but view it as distinct from, and complementary to, securitization markets such as those for GSE and privately issued MBS.

3. Should the government approach differ across different segments of the market, and if so, how?

- ***Commentary could address: differentiation of approach based on mortgage size or other characteristics; rationale for integration or separation of functions related to the single-family and multi-family market; whether there should be an emphasis on supporting the production of subsidized multifamily housing; differentiation in mechanism to convey subsidies, if any.***

Historically the GSEs and FHA/Ginnie Mae have acted within the bound of conforming loan limits. Thus, government support (implicit and explicit) has been focused on a limited portion of the housing markets. This regime reflected a view that the appropriate recipients of such support were homebuyers and homeowners with lower to moderate incomes, and that higher income borrowers would be served by banks through portfolio lending or private label securitization. Thus, the boundaries between public and private markets were in many ways determined by loan limits. This was not a strict rule, however, as private securitization included products that were below the loan limits but outside of the underwriting guidelines of the GSEs and FHA. Given the implicit support of the GSEs, and the benefits that conferred on their funding costs, private securitization markets generally could not economically compete with GSE MBS for conforming products. If Congress determines that changes to loan limits are necessary, we believe it is important that any changes be measured and gradual, to allow for private sources of mortgage funding to fill in the space once filled by the activities of the GSEs and/or FHA.

As we have discussed previously in this paper the ultimate existence and scope of the activities of the GSEs or their successors are policy questions. However, SIFMA members believe that there was, is, and will remain a role for private securitization markets in U.S. mortgage finance. Our members do not believe the current situation, where the GSEs and FHA support 95% of mortgage lending, is desirable, tenable, or healthy for taxpayers or housing markets in the long term. Therefore, we do believe the activities of any future GSE or successor should be circumscribed and targeted to where their economic impact would be maximized, and that private markets fill in around that space.

As noted previously and in the following section, SIFMA's Task Force supports the activities with respect to multifamily housing, and believes that if GSEs exist in the future that multifamily housing is appropriately within their purview.

4. How should the current organization of the housing finance system be improved?

- ***Commentary could address: what aspects should be preserved, changed, eliminated or added; regulatory considerations; optimal general organizational design and market structure; capital market functions; sources of funding; mortgage origination, distribution and servicing; the role of the existing government-sponsored enterprises; and the challenges of transitioning from the current system to a desired future system.***

Broad, Overarching Conclusions

At a high level, SIFMA Task Force members believe it is essential to preserve the benefits that securitization brings to lending markets. Chief among these benefits is the creation of a mechanism for private capital, and importantly, international capital, to flow to end users of consumer credit products. As discussed earlier, banks cannot replicate the scale and scope of these capital inflows with their balance sheets alone – securitization is necessary. This inflow of capital comes through both private securitization as well as GSE and government agency securitization, and we believe there is a complementary role for both.

While a number of problems have surfaced in the last few years, SIFMA's task force believes the appropriate approach is to fix what is broken, and bolster what worked. It does not make sense to discard products, services, and market practices that were demonstrably sound and beneficial to mortgage finance markets.

With respect to private securitization markets, industry participants are working to develop transactions that are palatable to both issuers and investors. This process will take time, and will require a meeting of the minds between and among issuers, underwriters, and the investors who buy their products. Recently we have seen the first RMBS transaction supported by new-issue loans. While this was but one transaction, it is at the least a promising sign that private mortgage securitization is not dead. We believe that significant time and work is in front of the industry before the private markets may be declared healthy, and it is important in the interim that the government not take actions that will preclude or otherwise significantly harm progress towards the restoration of vibrant private RMBS markets.

Some specific considerations for the GSEs follow.

The Specific Form of Corporate Organization, and Securities Issuance, by the Successor(s) to the GSEs is Flexible, as Long As It Provides for Homogeneity in Secondary Markets

The TBA market is based on one fundamental assumption – homogeneity. TBA trading is based on the assumption that the specific mortgage pools which will be delivered are fungible, and thus do not need to be explicitly known at the time a trade is initiated. At a high level, one pool is considered to be interchangeable with another pool. What this means for securities issued by any future GSE or successor entity or program is that regardless of how they are organized, or how many there are, the securities must look the same from the perspective of an investor. They should share the same guarantee, the same terms (payment day delay, etc…), and be for all intents and purposes fungible.

A Security Issuer Modeled After Ginnie Mae?

One option for securities issuance is to create a single entity that issues securities, modeled on GNMA (or, with appropriate staffing and resource and technology increases, presumably it could be GNMA). Regardless of how many GSEs are created, or even if any are created, one entity would issue the government guaranteed debt. This would provide for homogeneity and would minimize duplication of efforts on the part of multiple GSEs. SIFMA's Task Force would support such an outcome.

How Many GSEs?

If one entity is established to securitize loans, then questions of the appropriate number of GSEs becomes somewhat (but not entirely) less important, in the context of the maintenance of homogeneity in their MBS issuances. It is sometimes suggested that there should be more than two GSE-like entities in order to minimize systemic risk and "too big to fail" problems that are faced today, and on the surface, this would seem to be accomplished by creating five, six, seven or more GSEs. However, we note that each GSE will be placing the same "bet" on the housing markets, and thus the total risk across the system would not be reduced. Further, any future GSE is likely to be more strictly regulated and its activities more circumscribed or described alternately, less diversified. Thus the multiple GSEs would be significantly similar in terms of their activities, assets, and risk profiles. In the event of another significant downturn, the correlation between them will likely be 100%. Certain of these risks may be mitigated by a careful drawing of the boundaries of the activities of the entities in terms of products, activities, and risk limits, but recent experience has shown that unexpected events can devastate the most carefully constructed risk management plans. Thus, while the creation of multiple GSE-like entities could result in no single "too big to fail" entity, the risk of a systemic failure will still be present.

Furthermore, if the securities issued by the multiple entities were not sufficiently homogeneous in the eyes of investors, they would trade in separate TBA markets with reduced liquidity and higher interest rates for mortgage borrowers. An important factor for liquidity in these markets is the size of the market – that is, the available supply and new production of products for a given issuer, coupon, and term. Estimates vary on what is the minimum level of "tradable float" for a given product at the security coupon level, but it is safe to say that is it in the multiple tens of billions of dollars and most likely exceeds $50 billion per coupon (e.g., a liquid market in TBA eligible FNMA 5.5% coupon MBS would require at a minimum $50 billion of outstanding, tradable securities). Right now, there are distinct TBA markets for Fannie Mae and Freddie Mac securities, divided into the term (15 vs. 30 years) and further segmented by coupon. As the number of GSEs is increased, the number of TBA markets that will need to be supported by market makers and investors will increase ultimately reaching a point where fragmentation and operational complexity negatively impacts liquidity. Also working against liquidity will be the fact that the tradable supply in each distinct market will get smaller as more GSEs become issuers of MBS. Thus, policymakers must be sensitive to the need for significant issuance of homogeneous securities into a limited number of distinct markets to ensure liquidity. If the securities issued by multiple GSEs are not homogeneous, then liquidity will be impaired to the detriment of mortgage borrowers.

On the other hand SIFMA members do believe there is an important benefit to having more than one GSE. This benefit is not so much in terms of competition in terms of prices, products, or profits, which is the usual rationale for desiring a multiplicity of participants in a market (and which played a role in the demise of the current GSEs – especially competition with the private MBS markets). Rather, it is competition in terms of responsiveness to originators and investors. If only one GSE is created, what incentive will it have to be responsive to the needs of its originators? Originators will not have an alternative. Maintaining at least two entities would thus provide incentives for the GSEs to be responsive to their originator clients, and also to the needs of investors, for they would have to face a risk of losing business to the other. Given the considerable expertise and experience of the professional staff of both GSEs, it may be advisable to keep the current infrastructure as intact as is reasonable while still accomplishing the desired policy and reform goals. A strong regulator, as discussed below, would be needed in order to monitor the activities of the GSEs and ensure that this responsiveness does not turn into a repeat of a competitive "race to the bottom" similar to that which was experienced in the previous decade.

Portfolios Present a Number of Issues, But Ultimately At Least A Limited Operation Portfolio Is Needed

SIFMA task force members agree on an important overarching premise regarding portfolios – if they exist, whatever form portfolios take will require a clear mandate. One thing that is clear in the aftermath of the last two years is that inappropriate management the risk of the portfolios contributed to the inability of the GSEs to support the housing markets when their support was most needed.

Transactional Portfolios Are Needed To Keep MBS Markets Liquid and Provide Flexibility to Originators

Our members agree portfolios will be required if for nothing else but to facilitate securitization and standard maintenance of securities issuance programs, such as providing a holding facility for loans that are repurchased from securitized pools. Even if the GSEs or successor entity themselves do not issue MBS (i.e., it is issued by a GNMA-like entity), one would assume that the future GSE or successor entity would be the parties responsible for repurchasing delinquent, modified, or otherwise non-qualifying loans from securities. Furthermore, the GSEs currently provide to originators the ability to sell loans on a flow basis, that is, as they are originated, to the GSEs. The GSEs serve as an aggregator, and collect loans until a critical mass is reached and MBS can be issued. Further, portfolios also served a function of intermediating prepayment risk for smaller institutions that may not have had either the size or ability to economically manage such risks on their own. If GSEs were unable to provide these functions, smaller originators may have problems managing such risk, issuing MBS on their own due to warehousing costs and other issues, and they would be forced to sell their loans to a larger institution (a competitor) that could support a large portfolio of loans. This would likely have a negative impact on the pricing of their lending products to consumers. If portfolio activities were limited to serving this role, they could be capped at levels significantly lower than their current size and significantly mitigate current concerns around systemic risk they present.

However, some SIFMA members believe that the portfolios should serve a somewhat broader purpose than simply facilitating securitization of single-family mortgages.

Multifamily Lending has Generally Been a Portfolio Product

The GSEs have traditionally played an important role supporting multifamily lending programs, especially through their retained portfolios[3]. While these programs are smaller than the traditional single family business, they are no less important to many homeowners and renters. However, the multifamily markets have not lent themselves to supporting a liquid MBS market akin to that of single family products to this point. One reason is because the collateral is less homogeneous and more concentrated, and another is simply due to the size of the markets compared to single family – they are much smaller. Thus, the GSE portfolios have played a very important role in supporting multifamily lending, and if this support is withdrawn it is not clear what will provide needed liquidity to multifamily lenders. Task force members note, however, that if successors to the GSEs were to issue multifamily MBS that were government guaranteed, there would be a market for it. The policy question is whether or not this market would provide pricing that enabled the desired amount of multifamily finance. Whether or not the GSEs have portfolios, SIFMA members believe that multifamily activities should remain within the scope of acceptable activities for GSEs or successor entity in the future. We do not believe that multifamily markets will operate efficiently without this support.

Historic Role of the Portfolios, and the Question of the Need for a MBS Market Backstop

Prior to 2008, the GSE portfolios played an important role as a kind of backstop or source of liquidity of last resort for their MBS markets, providing demand in areas where demand was weak. In this case, the profit motive of the GSEs incented them to buy their own MBS when it was "cheap". This activity mitigated volatility, serving to keep mortgage interest rates more stable. Given this past role, many SIFMA task force members believe that in the future portfolios can and should play an important role as a countercyclical buffer, stepping in to create stability in mortgage markets when private investor demand is weaker. Due to the GSEs' difficulties, the Federal Reserve played this role throughout 2009, although to an extreme far beyond the traditional role of the GSEs.[4] Many members of the SIFMA task force believe that the GSEs or successor entities should retain portfolio functions for these purposes, but limited to activities with respect to conforming products. Furthermore, many task force members believe it is appropriate for any portfolio functions beyond an operational portfolio supporting the guarantee business to be housed in a separate entity or otherwise completely walled off from the guarantee business.

A challenge with this approach relates to the motivation for GSE or successor entity to play this role. As noted above, in the past the profit motive of the GSEs provided incentives to purchase "cheap" securities in the secondary market. However, the downside of this profit motive was that the GSEs arguably did not have incentives to shrink the portfolios in times when they were not necessary to provide stability to the markets. Given that any future GSE or successor entity is likely to have a moderately or extremely

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[3] According to the 2008 FHFA annual report, at the end of 2008 Fannie Mae held $117 billion of multifamily loans in addition to the outstanding $38 billion in multifamily-backed MBS. Freddie Mac held approximately $72 billion in multifamily loans in addition to its $13.5 billion in outstanding MBS issuances. 2008 FHFA report available here: http://www.fhfa.gov/webfiles/2335/FHFA_ReportToCongress2008508rev.pdf

[4] The Federal Reserve entered the market with a mandate to push mortgage rates down and increase affordability of mortgage products, as well as to drive investment out of GSE MBS and in to other financial products to support those markets, through what the Fed calls the "portfolio balance channel". See remarks of Brian Sack, Executive Vice President of the Federal Reserve Bank of New York, available online: http://www.newyorkfed.org/newsevents/speeches/2009/sac091202.html

reduced motivation and/or ability to earn unlimited profits, it is somewhat unclear what would incent the GSE or successor entity to purchase securities in this manner. That being said, there may be a nexus between this portfolio function and guarantee fees charged by the GSEs, in that, if a GSE were organized as a utility or otherwise with strict ROE or earnings targets, when portfolio profits were higher, guarantee fees charged by the entity could be reduced, and when portfolio profits were lower, guarantee fees could be increased. This would create incentives for portfolios to shrink in times when MBS were not "cheap" and providing sufficient returns. However, it is unclear if such a portfolio would be able to attract the level of talented professionals that would be required to manage such an important function.

Assuming the GSEs were allowed to play this role, appropriate maximum sizes for the portfolios could be implemented if desired. This number would likely be somewhere above zero but significantly smaller than the current $900 BN cap faced by each GSE. The maximum size should be clearly related to the capital of the institution and the overall size of the mortgage markets. Should the markets require support above and beyond the capacity of these limited portfolios, it is likely that the nation would be facing another financial or economic crisis that would make direct, explicit government intervention in all likelihood necessary. Regardless of the ultimate level of the cap, graduated capital standards may be appropriate in order to incent appropriate risk management as the portfolios grow.

Significant challenges exist, however, to creating portfolios that are able to expand quickly from de minimis levels to larger sizes to provide support to mortgage markets. Presumably the GSEs or successor entity will need to issue debt to support a portfolio expansion (discussed further below). However, if there is not a significant supply of outstanding debt, liquidity for new issuances and the market's capacity to absorb significant quantities of securities will be limited. Therefore the ability of the GSEs or their successors to provide support may be limited by (a) the absolute amount of debt they are able to issue in a short period of time, and/or (b) the cost of the debt issuances. Thus, if portfolios are expected to fill this role of a balance sheet of last resort, they will need to have a steady state level that provides enough liquidity so that their sizes can be increased quickly in case of emergency.

Ultimately the question of whether or not a backstop bid is required for MBS markets is a policy choice. While a portfolio that played this role could have the effect of smoothing out volatility, it is important to keep in mind that some degree of volatility is normal for a financial market. It can also be argued that if the GSEs or their successors effectively and consistently transmitted investment capital from investors in MBS to the banks that make loans to borrowers that this by its very nature would have the effect of smoothing out volatility in mortgage rate, and that their portfolios are not needed for this process to take place. The smoothness that is obtained may not be to the same level as if they were also actors with portfolios, but questions of the socially desirable level of mortgage rate volatility are not questions for markets, but rather policymakers.

Larger Policy Questions Regarding Portfolios

The issue of portfolios raises a relevant policy question – if the portfolios are meant to serve a public policy purpose (stability in the mortgage markets/balance sheet of last resort), should they be housed within an official arm of the government (such as the Treasury) or reside in private or semi-private markets? One major difference between the past portfolio activities of the GSEs when compared to the Federal Reserve's effort is that, generally speaking, the GSEs acted with economic motivations with respect to their own MBS, and other market participants were better able to discern why the GSEs acted as they did, and have a better window into where these large, important players may next act. In contrast, the actions of the Federal Reserve have stemmed from a macroeconomic policy goal as opposed to a relative value, profit motivated goal, and have caused market distortions due to their unique nature. If the portfolio is housed within a government entity, it could have an appearance of being a price targeting mechanism, and be considered to be more likely to act with non-economic motivations that could lead to distortions of the market. Ultimately, a portfolio that did not act in accordance with economic principles could lead to meaningful distortions of the MBS market.

Most of the task force members believe GSEs or their successor entities should be prohibited from purchasing anything other than their own conforming MBS. However, some task force members strongly believe that if properly managed, retained portfolios including non-conforming assets would serve an important function commensurate with broader policy goals. This view is based on a premise that portfolios are not inherently bad, but rather that mismanagement of risk caused the problems we are now dealing with. These members note that the GSEs could serve as providers of seed capital to small or new markets that have not yet developed strong liquidity on their own.

All in all, the task force members believe a retained portfolio in some form is necessary on a purely operational basis, at a minimum. Beyond this level of activity, policy choices must be made regarding the role that a portfolio could play in mortgage markets. A portfolio could have a special role in multifamily markets; and if policymakers determine that smoothing out significant volatility and liquidity disruptions is a policy goal, a portfolio housed either in a GSE-like entity or an agency of the government would be a means to accomplish that goal.

Considerations for GSE Corporate Debt

Task force members agree that if the GSEs or successor entities maintain portfolios of any significant size, such portfolios will need to be financed, and this most logically will come through the issuance of corporate debt. This raises the question of whether such corporate debt should carry some form of a government guarantee like that proposed for MBS as previously discussed.

Some task force members believe it might be difficult for the GSEs or successor entities to issue non-guaranteed debt in significant volumes, if at all, in times of financial or economic stress. One solution to this problem might be to establish a permanent financing facility for the GSEs within the Treasury Department or the Department of Housing and Urban Development. On the other hand, GSEs that issue guaranteed debt will achieve a funding advantage over non-GSE market participants. It is conceivable that these competitive issues could be addressed through regulation; in any case issues around the corporate debt of the entities need to be considered in more detail. They are not, however, directly related to the issues which are central to this document, those being liquidity and capital formation for mortgage markets. We also note that to the extent that the GSEs are limited to owning government guaranteed MBS, this would likely confer benefits to their debt issuances, as they would be perceived as safer.

Transition Issues and Resolution of the Conservatorships

-Guarantee Needed For Existing Securities

SIFMA Task Force members believe the government must clearly state intentions with respect to legacy GSE issues prior to and during any transition, and that existing GSE MBS and corporate debt should be explicitly guaranteed. Bifurcation of markets into pre- and post-reform markets should be avoided at all costs. Especially for the MBS, considerations of bridging the assets from the 'old' market into the 'new' market will arise. Exchange programs for existing assets could be arranged in the event that terms of securities under the new regime materially differ from terms of existing securities. These exchange programs have been executed in these markets in the past, and lessons learned from those experiences can guide future operations.

-Creation of a Wind-Down Vehicle

In terms of addressing issues with delinquent, poorly performing, or non-conforming assets held by the GSEs, SIFMA Task Force members are in general agreement that existing "bad" assets should be spun off into a wind-down vehicle (i.e., assets split into a good bank/bad bank arrangement). Determining the structure of the vehicle involves tradeoffs: Both existing GSEs could become wind-down vehicles (or merged into a single vehicle) and new activities carried out in a new entity. This would provide the benefit of nominally providing a "fresh start" and allowing policymakers to "eliminate" Fannie Mae and Freddie Mac, which could confer some benefits. On the other hand, seemingly simple things like name changes of the enterprises will present significant operational challenges for investors in terms of requirements for new investment committee approvals, documentation, IT systems, and other similar issues. Therefore it may be easier to simply create a new entity and transfer the bad assets into that entity.

-The Challenge Is To Determine What Is "Good" And What Is "Bad"

Non-agency assets held in the retained portfolios of the current GSEs may be easily identified and placed into the wind-down vehicle. SIFMA Task Force members believe that loans held in the existing portfolios should also be placed into the wind down vehicle. Many existing Agency MBS securities held in portfolio, however, are composed of good and bad assets.

One option for these existing securities would be to place bad loans bought out of securities into the bad bank as they are repurchased. However this would involve some degree of operational complexity and inefficiency. Therefore it may be advisable to place all existing portfolio holdings into the wind-down vehicles. If some of the wind-down vehicle's assets perform well, that will only serve to reduce the ultimate costs of the wind down process. Additionally, assets in the bad bank need the same transparency or better than they have now as they will be an excellent source of market information.

Our members have reached a general consensus that the easiest and most efficient way to separate assets is to draw a clear line on the date when the GSEs are reorganized. Assets held by the GSEs before that time would be placed in the bad bank, and assets created after that time would be placed in the good bank. If there is a policy goal to retain assets in the new companies to the extent possible, then only non-conforming assets (by the new definition of non-conforming, whatever that may be) could be moved into the wind-down vehicle.

Policymakers Must Provide for a Strong Regulator and Strong Capital Adequacy Standards, And Define a Clear Mission for Successors to the GSEs

It is clear that due to poor risk management, flawed business strategy and other management and policy failures, the GSEs became insolvent. Part of the blame for this can appropriately be ascribed to the fact that the GSE's former regulator, OFHEO, lacked certain powers that were appropriate for its role such as the ability to freely adjust risk based capital standards, better regulate the management and activities of the GSEs, and place the entities into a conservatorship as opposed to receivership, if needed. This has been at least somewhat rectified since 2008 with the creation of FHFA. Going forward, any GSE must continue to be regulated by a strong, empowered regulator with the powers to disallow practices that have become too risky, enforce appropriate capital standards, and to reign in competitive excesses that threaten the stability of the organizations. For this to be possible, the regulator must be sufficiently funded so that it is able to develop a staff with the requisite expertise and experience to manage such an important role. Presumably fees on government reinsurance could fund the regulator. In any case, it will be important to market participants that the future entities, if they exist, are properly regulated as to avoid a repeat of recent history.

5. How should the housing finance system support sound market practices?

- ***Commentary could address underwriting standards; how best to balance risk and access; and extent to which housing finance systems that reference certain standards and mortgage products contribute to this objective.***

Bad Underwriting is at the Center of Market Disruption and Key to Future Success

At the center of the recent market distress lies bad underwriting. The crisis spun out of control because of the pervasiveness of poorly performing products; poorly performing products became so pervasive because relaxed underwriting standards allowed volumes of loan origination to expand to unsustainable levels.

While many reforms have been proposed, suggested, and/or implemented, the most effective check on future excesses would be regulation of mortgage underwriting that requires that lending be sensible and based on some reasonable expectation of repayment. Of course, a balance needs to be stuck between access to credit and assurance of repayment, as it is unreasonable to expect that each and every borrower will repay his or her loan. But the bottom line is that attempting to regulate primary lending markets through regulation of securitization and other secondary markets is by definition inefficient, will cause distortions, and will be likely to see only uneven success. We note that while improvements to underwriting can help lead to a safer system, they will not entirely eliminate systemic risk. The system will still be vulnerable to exogenous shocks, however, it should have a more solid base of support to withstand such events.

The GSEs traditionally have been a reference point for origination standards. They also, as discussed above, have fostered the development of beneficial products such as 30 year mortgages, and standardized documentation.

Some thoughts on the role of underwriting standards and the future of the GSEs follow.

Role for Government and the Regulator in Setting Underwriting and Risk Management Standards for GSEs and any Successor Entities

The GSEs were established with a clear public policy goal of providing a stable source of funding for the mortgage market and thus mortgage availability and affordability for homebuyers. Arguably the GSEs got into trouble when they strayed beyond their original mission whether by their choice or because of policies that incented the GSEs to stray. It seems appropriate that an explicit government guarantee, such as what we have suggested above, should be matched with an explicitly defined mission specifically as it relates to product and credit parameters. We believe it is appropriate for policymakers to make decisions regarding what mortgage products should be the beneficiaries of government support. It is also appropriate for the government, if it offers a guarantee, to set out in a broad manner uniform underwriting standards that appropriately balance the availability of credit to deserving borrowers and the risk they present to the government insurance program. Historically, SIFMA has supported efforts of legislators to develop uniform regulations and laws regarding mortgage lending; by regulating the activities of the conduits of the majority of mortgage lending, a similar purpose may be achieved through a more appropriately market-based mechanism. In other words, if policymakers have a view as to what is the most beneficial form of mortgage lending, that can be the area in which the GSEs or their successors operate. Lending products that fall outside of that area will be forced to stand on their own, and attract investment capital through their own merits and performance.

That being said, our task force members believe that there are sound market efficiency reasons to preserve the ability of the GSEs or their successor entities to implement specific policies and criteria, such as risk-based pricing or underwriting guidelines, within broader parameters outlined by Congress and their regulator. We note that FHA has struggled to implement risk based pricing for its program, which has resulted in negative consequences for the performance of FHA's insurance fund.

This limited flexibility would allow the GSEs to react to changing market conditions, and with an appropriate risk management infrastructure in place, provide an efficient service to the economy.

6. What is the best way for the housing finance system to help ensure consumers are protected from unfair, abusive or deceptive practices?

- ***Commentary could address: level of consumer protections and limitation; supervising agencies; specific restrictions; and role of consumer education***

The best protection for consumers will be the development and maintenance of sound underwriting principles. We note that while many policy efforts have aimed at the secondary markets, such as risk retention, assignee liability, or otherwise, the most impactful, direct, efficient, and effective means to regulate lending standards is by actually regulating lending standard. The answer is not to use the secondary market as a policeman for primary markets; rather, primary markets need direct attention. Furthermore, the market values of loans and mortgage-backed securities are determined by the integrity of the origination process – this is aligned with the interests of mortgage borrowers.

7. Do housing finance systems in other countries offer insights that can help inform US reform choices?

SIFMA's task force acknowledges that other countries have developed mortgage finance systems that have been successful and resilient through the recent market disruptions – Canada and Denmark are commonly noted. While we agree that these arrangements have worked for these countries, these models are not "the answer" to issues faced by the U.S. We do believe that policymakers should look to what has worked for these countries and if, and how, it could be applied to the U.S. However we do not believe a broad-brush general application of the foreign systems can be simply transferred to the U.S.

As a general matter, we note that both Canada and Denmark's mortgage markets are fractions of the size of the market in the U.S. and are significantly more homogeneous and geographically concentrated. They are likely not scalable to the size of the U.S. markets. We also note that in many other countries, fixed rate mortgages are not predominant. The unique characteristics of the U.S. economy, geography, and populace have led to the development of a mortgage finance system that is customized to its needs. While a number of problems have become painfully apparent in the last few years, our Task Force does not believe it is appropriate to discard the fundamental underpinnings of the system and attempt a wholesale importation of a foreign country's policies. Each of these other countries have likewise developed a mortgage finance system customized to their needs; importing the U.S. model there would be similarly unlikely to succeed.

As discussed above, we believe that ultimately the best approach to the U.S. mortgage market should be focused on the U.S. mortgage market, and central to that focus is to ensure that underwriting policies and practices are robust and promote sound lending.

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