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hearing on

"GSE Reform: Immediate Steps to Protect Taxpayers and End the Bailout"

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Introduction

Mr. Chairman and members of the committee, I am honored to have the opportunity to share some thoughts on GSE reform.

This testimony benefits from over two years of conversations with the Mortgage Finance Working Group, sponsored by the Center for American Progress. The members of this working group began gathering in 2008 in response to the U.S. housing and financial crises in an effort to collectively strengthen their understanding of the causes of the crises and to discuss possible options for public policy to shape the future of the U.S. mortgage markets. I am grateful for all I have learned from these colleagues, but of course I speak only for myself in the views expressed here. I also offer my thanks to CAP's David Min and Lauren Bazel for their assistance in preparing this testimony.

The invitation to appear today spoke of the committee's goals of building a stable housing finance system based on private capital and minimizing taxpayer losses. I share these objectives. What is more, I agree that the current situation is unsustainable. We find ourselves—in the aftermath of badly designed mortgages, mispriced risk, excessive leverage, and lack of supervision that triggered the financial crisis—with government bearing the credit risk on the vast majority of residential mortgage lending. Private capital must be encouraged to bear as much of the load as possible in our housing finance system going forward. We can begin that process by carefully restoring the private sector's appropriate role in our home mortgage market place.

Our nation's goals, however, should also include some other things that are important to the American people, including:

- Decent, safe, and affordable rental and homeownership options alongside an adequate supply of rental and residential housing so that American families have *appropriate* housing *choices* to meet their circumstances and needs
- Access to the American Dream of homeownership for those creditworthy borrowers who are ready to sustain the responsibilities that accompany a mortgage
- Fair, equitable, and nondiscriminatory access to credit so that the color of one's skin or the composition of the neighborhood of one's home does not determine availability of credit
- The opportunity to rebuild (based on sound and sustainable lending principles) those communities where every fourth house is now in foreclosure, where homeowners' equity is long-gone, and where vandalism, crime, and community deterioration are today the result of the mortgage crisis
- And a diverse housing finance system that is not dependent on a handful or large and ultimately too-big-to-fail financial institutions but rather also includes community banks and other local financial institutions that can compete and offer products to meet the needs of the communities they know best

I will argue that some of the policy prescriptions offered by others testifying before this panel today would not only fail to accomplish these additional goals but also put at risk the Committee's stated goals of broad economic and housing market stability and taxpayer protection. We have learned all too painfully just how closely our economy's fate is tied to housing market stability. If American families see home values continue to fall over the next two years, then still shaky consumer confidence will collapse, bank balance sheets will suffer, credit availability will tighten further, and the vicious circle of falling home values will resume. With housing markets struggling with an enormous overhang of inventory and weak employment, we can ill afford to take any further missteps in housing policy.

In this testimony, I first lay out some principals that should underlie housing finance reform. Then I discuss how to achieve the Committee's stated goals of attracting private capital and reducing taxpayer losses. There are some important preconditions for successfully reducing our reliance on the GSEs in conservatorship and the return of a private securitization market, including completion of the implementing regulations regarding the mortgage market under the Dodd-Frank Act and the development by industry and regulators of industry standards for servicing. I argue that we must ensure that the private market is ready to resume serving portions of the market before we begin to withdraw the GSEs or we could have significantly distorting effects on home values and economic growth.

Then, I will argue that we must have a long-term plan in mind for what replaces the GSEs so that we can build a smooth transition. Taking some of the steps recommended by other panelists would serve the goals of our system badly. So finally this testimony describes some possible consequences of the radical privatization proposals that have been offered to the committee. These proposals would take us to uncharted territory. The reason: Despite assertions to the contrary, no developed country has a private housing finance market without government support in one form or the other. After the sorry consequences of our dangerous experiment with private-market innovation over the precious decade, I will caution against going down that path—leaving American families who have already suffered the worst economy in our lifetimes to once again pay the price.

Principles of reform

A new housing finance system should be based on five key principles: liquidity, stability, transparency, affordability, and consumer protection. I describe these goals below and then explain what these mean in lay terms for American families.

First, there must be broad and constant liquidity

The new system needs to provide investors the confidence to deliver a reliable supply of capital to ensure access to mortgage credit for both rental and homeownership options, every day and in every community, during all kinds of different economic conditions, through large and small lenders alike.

Broad and constant liquidity also requires effective intermediation between borrower demands for long-term, inherently illiquid mortgages and investor demands for short-term, liquid investments. Because long-term, fixed-rate loans impose both interest-rate risk and liquidity risk on lenders, they have become increasingly unwilling to hold these loans on their balance sheets. The capital markets therefore have become increasingly important to the intermediation necessary for mortgage finance. But as the past decade so stunningly demonstrated, left to their own devices capital markets provide highly inconsistent mortgage liquidity, offering too much credit sometimes and no credit at other times.

It is also important to consider the distribution of mortgage originations. Currently, an estimated 70 percent of all mortgage originations flow through four lenders—JP Morgan Chase Co., Bank of America Corp, Citigroup Inc., and Wells Fargo & Co.—all of which benefit from federal deposit insurance and the perception that they are too big to fail. Without consistent and equitable access to a fairly priced secondary market, the country will be in danger of losing the services of community banks, credit unions, and other lenders that can meet the needs of their communities on a more tailored and targeted basis than these larger institutions. These many small but important financial institutions need a well-functioning secondary market so they can access the capital they need to originate more mortgages.

What does consistent liquidity mean for American families?

It means that developers will find capital to finance new apartments and other homes so that families will not see their rents spike as growing demand and inadequate supply put decent rental options out of reach. It means that regardless of what community they live in lenders will offer them credit at a fair price. It means that families will be able to afford a long-term mortgage that offers a fixed housing cost that they can budget for the costs without fear that interest rates will drive up their costs and force them to relocate. It means they can put their hard earned savings into a home with confidence that, whether the economy is up or down, when they need to sell to move to be near an ailing family member or to get a new job, potential buyers will have reasonable access to credit from an array of competing lenders and the family will be able to sell their home at a fair market price.

Second, any new system must foster financial stability

Stability is best achieved by reining in excessive risk taking and promoting reasonable products and sufficient capital to protect our economy from destructive boom-bust cycles. A totally private mortgage market is inherently inclined toward extreme bubble-bust cycles, which cause the misallocation of capital and result in significant wealth destruction that brings with it devastating repercussions not only for homeowners and lenders but also for neighborhood stability, the larger financial system, and the broader economy.

Mortgage lending is inherently procyclical. Mitigating that tendency requires strong, consistently enforced underwriting standards and capital requirements that are applied equally across all mortgage financing channels for the long cycle of mortgage risk. As we saw in the previous decade, capital arbitrage can quickly turn small gaps in regulatory coverage into major chasms, causing a “race to the bottom” that threatens the entire economy.

To stabilize the mortgage markets and the economy, sources of countercyclical liquidity are required. Lenders are naturally inclined to minimize risk-taking during uncertain economic times, but the resulting absence of credit can severely exacerbate economic distress in a “vicious circle” of falling asset prices, increasing credit defaults, and reduced availability of loans. This problem is especially acute in economically distressed regions and communities. The system has to be able to make sources of mortgage liquidity available during housing and economic downturns.

What does housing market stability mean for the American family?

It means that they will not experience wild fluctuations in home values. Markets will go up and down, so families cannot be protected against all changes in value, but market stability means that speculation will not create a bubble that inflates family housing costs and then lead to a bust that will destroy their savings.

Third, transparency and standardization will support these other principles

Underwriting and documentation standards must be clear and consistent across the board so consumers, investors and regulators can accurately assess and price risk and regulators can hold institutions accountable for maintaining an appropriate level of capital. Similarly, when standardized mortgage-backed securities trade in transparent markets, investors and regulators can understand the actual risk of both instruments and institutions and markets can price securities accurately.

During the housing bubble, the housing finance system experienced a seismic shift toward complex and heterogeneous products, from nonstandard mortgages that could not be understood by consumers at the bottom of the chain to securities that could not be traded due to their complexity at the top. This lack of transparency and standardization resulted in opacity and adverse selection because the issuers knew more than the investors. The yields investors demanded to take on risk decreased while the risk of the underlying assets increased. It is unlikely that a private mortgage-backed securities market will reemerge unless investors are convinced these problems have been resolved.

Moreover, because the state of the whole secondary market affects the pricing of each packaged pool of mortgages in it, a safe and liquid securitization market can only exist if investors have access to information about all mortgage-backed securities in the market place. Mortgage-backed securities pooled together by any institution will not be priced properly if alternative investments that are in fact more risky are priced as if they had the same risk characteristics as those in other pools. Standardized data fields with verification

of data are necessary for all mortgage-backed securities. Finally, no securitizer should be allowed to issue products that cannot be analyzed using standard financial models.

What does standardization and transparency mean to the American family?

First of all, it means that they can make good choices in their family's best interest. The mortgage products they can choose from are not so complex that their consequences are hidden. But families also benefit from a market where their mortgages packaged into securities are traded in a transparent market where investors are confident they can assess risk from well understood and standard products. In the aftermath of the housing and financial crises, investors will charge a significant risk premium (if they will invest at all) if they cannot become confident that they understand the mortgage assets underlying the securities that they purchase. Secondary market transparency and standardization lower costs and increase availability.

Fourth, the system must ensure access to reasonably priced financing for both homeownership and rental housing

One of the most important accomplishments of the modern U.S. housing finance system is the broad availability of mortgage credit. Liquidity and stability are essential to affordability, but they will not do the job without specific attention to whether private mortgage credit is affordable to support appropriate and sustainable homeownership and quality rental options for Americans.

For most families, the lower housing costs produced by the modern mortgage finance system over the past half century (before the recent crises) facilitated wealth building, enabling them to build equity, save, and invest. This contributed to the building of a strong middle class. An important guiding concept in modern U.S. housing finance policy—and a key component of the American socioeconomic mobility of the 20th century—is the principle that housing costs should ideally comprise no more than 30 percent of income. This should remain a central principle of the system that is created for the 21st century as well.

A pillar of this housing system is affordably priced long-term, fixed-rate, fully self-amortizing, prepayable mortgages, such as the 30-year mortgage. The long term of this loan provides borrowers with an affordable payment, while the fixed-rate, the option to prepay, and self-amortization features provide the financial stability and forced savings that are critically important to most families, while retaining the opportunity for mobility.

Multifamily rental housing also gains stability from long-term, fixed-rate financing. Banks and other lenders, however, are reluctant to offer long-term, fixed-rate mortgages to homebuyers or multifamily mortgage borrowers unless the lenders have a consistently available secondary market outlet. In the absence of government policies designed to explicitly support long-term, fixed-rate mortgages, it is likely that this type of mortgage would largely disappear from the U.S. housing landscape or become unaffordable to the

nation's middle class, which has been so effectively served by 30-year residential mortgages, and to the nation's many renters who rely on multifamily property owners' ability to finance and refinance their apartment buildings.

Affordable housing finance must also be available for areas that are not well served by mainstream financial channels, including multifamily rental housing and nontraditional credit risks such as prospective first-time homebuyers with incomes sufficient to support a mortgage but who are unable to raise a large down payment. We have ample evidence that many households who may not fit the 20 percent down, established credit, 30 percent debt-to-income" model can become successful long-term homeowners, when given access to well underwritten, affordable, fixed-rate financing.

What does affordability mean for the American family?

It does not mean that people should stretch to purchase more house than they can afford. It does mean that homeownership's benefits of forced savings and wealth appreciation are available to those with sustainable incomes and strong credit history without regard to race or geography. It also means that there is enough supply of quality rental housing appropriate for individuals and families so that rents charged are affordable—meaning housing costs are no more than 30 percent of incomes.

Finally, the system must support the long-term best interest of all borrowers and consumers and protects against predatory practices

The purchase of a home is a far more complicated, highly technical transaction than any other consumer purchase and occurs only a few times in a consumer's life. Mortgage consumers are at a severe information disadvantage compared to lenders. In addition, a mortgage typically represents a household's largest liability. A mortgage foreclosure therefore has outsized consequences for the borrower. As the current crisis so sadly demonstrates, mortgage foreclosures also delivers devastating consequences to communities, the financial markets and the broader economy.

During the housing boom, unregulated and often predatory subprime lending not only failed to maintain or promote sustainable homeownership opportunities but also established a dual credit market where factors other than a borrower's creditworthiness—such as race or neighborhood location—determined the type and terms of the mortgages available. All too often, families were denied the best credit for which they qualified because their communities were flooded with unsustainable mortgage credit—in part because secondary market pressures created incentives to make and sell these loans.

What does consumer protection in housing markets mean to American families?

It means that there is a counterweight to the persistent problem of information asymmetry that typically tilts the mortgage finance system to disadvantage consumers. It means that they need not fear rip-offs and predatory practices, pitched by those who would profit

from selling them unsuitable profits and stripping them of the savings and home equity that their hard work had produced.

How to responsibly attract private capital to return to the housing market

Understanding the current government backstop

Today, the federal government backstops some 90 percent of all home mortgage loans. Nearly half of the home purchase loans are guaranteed by the Federal Housing Administration, the Department of Veterans Affairs, or the Department of Agriculture's Rural Housing Services programs. Almost all other home mortgage loans and most mortgage refinancings are financed through Fannie Mae and Freddie Mac, both of which are now in government conservatorship. The private secondary market in home mortgages disappeared in 2008 and remains moribund. Fannie Mae and Freddie Mac also now purchase more than 80 percent of all multifamily mortgages, loans to owners, and developers of rental residential properties.

Let us be clear how these loans work. In the case of FHA, VA, and RHS loans, the federal government is effectively guaranteeing the lenders (or investors if these loans are securitized into Ginnie Mae securities) that they will be repaid their principal and interest if the borrower defaults, minus some transaction costs. In other words, the credit risk on a loan-by-loan basis is on the taxpayer. Today, FHA collects premiums to help pay for this insurance and, under most imaginable scenarios, those premiums will be sufficient to cover any losses FHA incurs on this insurance. If so, FHA's record since 1934 of operating at no cost to the taxpayer will be preserved. But the risk of these loans is on the government. **And so we should seek to reduce that risk, and have the private sector serve more of the need, when that can be achieved without destabilizing the market.**

In the case of the GSEs, the investor in Fannie Mae or Freddie Mac mortgage-backed securities are effectively getting a guarantee from the GSE that they will repay loan to the investors if the borrower defaults, from the GSEs' own capital and the proceeds of recoveries. But of course the GSEs capital became so thin that they had to be placed in conservatorship and they now may draw down from funds made available by the Treasury to fulfill these obligations. So, again, taxpayer resources are effectively supporting the market. **The upshot: Restoring private at-risk capital ahead of the taxpayer must be a goal of reform.**

Preconditions to restoring a private securitization market

So what must happen to draw private capital into the system? First, private-label securities backed by well-regulated, high-quality mortgages above the conforming loan limit could return. But so far, there has been one only private securitization deal since the 2008 financial crisis, a $238 million deal underwritten by Redwood Trust, which

consisted entirely of 5-year jumbo adjustable rate mortgages with a 43 percent average down payment, of which 73.74 percent were interest-only ARMs for the first 10 years.

Evidence suggests that other jumbo loans currently available, including a small market for fixed-rate jumbo loans, are provided by portfolio lenders to their high-end customers with exceptional credit profiles. But there is little reason to believe these banks have sufficient capital to originate and leave on their balance sheet comparable products serving the mainstream conventional market.

The investors in the Redwood deal all conducted extensive due diligence. While the relative success of this deal has prompted several other firms to plan their own jumbo securitizations, given the parameters of the Redwood Trust deal it is hard to imagine private-label securitization coming to scale to take any significant part of the conventional market in the near future.

But why not? I see a variety of important barriers to private securitization. . The first is the necessity of clarifying the rules implementing the Dodd-Frank Act. Regulators are hard at work drafting definitions of the "qualified mortgage" and "qualified residential mortgage." Loans meeting this new QM definition benefit from a safe harbor against certain liability. Similarly, under section 941 of the Dodd Frank Act, securitizers are to retain at least 5 percent of the risk on asset-backed securities issues, but issuances composed entirely of loans meeting the QRM definition are exempt from that requirement. The sooner that these rulemaking processes are complete, the sooner the ground rules for securitization will be clear and the sooner investors are likely to return. Those who would delay these efforts undermine the certainty they claim the markets desperately need.

A second barrier today is the lack of investor confidence in private-label securities themselves. Restoring confidence will require regaining trust that mortgage service companies are acting in the best interest of investors. It turns out that, products developed during what seemed like perpetual house price appreciation, did not spell out clearly standard practices for the defaults and declining market circumstances we faced in this crisis. We are hearing that most investors who do not have the capacity to do their own due diligence on all the underlying collateral want to see new industry-standard servicing practices that provide the servicers the right incentives to service loans to maximize investor return, including to modify loans or use other loss mitigation techniques where doing so would provide a better outcome for investors.

The mortgage servicing industry and regulators has just begun a comprehensive look at servicing standards. Standardizing and clarifying servicing practices is a necessary precondition for investor confidence in securitizations that do not carry a government guarantee of return on investment. When this new system is in place, private label securities will attract institutional investor interest once again.

Of course a third barrier is the comparative pricing advantage of GSE-backed lending given the government's lower cost of capital. It will be difficult for issuers of private-

label securities to directly compete with the GSEs in the current context. When these other barriers to private-label securities are removed, however, and the housing market appears to have stabilized, it will make sense to gradually reduce the GSE conforming loan limit from its current high level to invite the private market back in and give it a larger swath of the market in which to develop new capacities.

Yet I fear the consequences of lowering the conforming loan limit too sharply before some of these other steps are also taken. If the loan limit were to fall and the private securitization market was unable to provide capital for homes above a newly reduced conforming loan limit, then homes valued in that band will find credit constrained and it will have an effect on the ability to find buyers, the ability to sell homes, and the value of homes whether or not on the market. In such a fragile economy, policy-induced home price declines seem unwise.

Loan limit declines must come so that the government backstop is increasingly focused on the lower part of the market where middle class families live, as the Center for American Progress and its Mortgage Finance Working Group recommend. But they must not come before we have certain essential pieces of a new system in place so that the private market is in a position to take their place and we do not experience unnecessary shocks to the broader economy.

Putting private capital ahead of the taxpayer

The path described above of attracting private securitization so that it can gradually assume a larger share of the market now served by the GSEs is not alone sufficient to accomplish the housing finance goals I described above. Even if accomplished gradually as the private securitization market's capacity and readiness is established, stepping aside from the entire market will leave us vulnerable to bubble-bust cycles, with market segments and communities without a liquid supply of mortgage credit on fair and sustainable terms, as further described below.

But the status quo and radical privatization are not the only two options. A third option exists in which fully at risk private capital stands ahead of a limited government guarantee of mortgage-backed securities sufficient to attract a highly liquid market for middle class housing finance needs. What is more, private investors should be asked to pay a premium into a Catastrophic Risk Insurance Fund that would work much like the FDIC to protect taxpayers against risk of loss, with the ability to recoup reserves after periods of economic stress. This long-term option, to serve the middle market, would achieve the Committee's goals of attracting private capital and limiting taxpayer risk while also achieving the other goals described in the first section above.

It is beyond the scope of this testimony to describe how such a proposal might work. Many such options have been produced, including one from the MFWG published by CAP. For purposes of today, however, it is sufficient to emphasize that the Committee's goals of reducing risk of loss and attracting private capital can be achieved in ways that

do not abandon the other objectives of liquidity, stability, and affordability so important to American families and our larger economy

Strategies for reducing taxpayer losses

Another goal of this hearing that I share is to reduce taxpayer losses. Some of the proposals described here today might have the opposite effect. Specifically, premature shutting down of the existing GSEs without a system to replace them would be counterproductive, and could prevent the taxpayers from recouping some of the capital that they have invested in the GSEs to keep the housing market afloat.

On October 10, 2010, the Federal Housing Finance Agency published projections of likely future draws against the Treasury through 2013 as well as dividend payments. While it is important to note that any such projections depend on house prices and other factors that are hard to predict, the FHFA predicts that payments of the dividends to taxpayers for their capital investment in the GSEs to prevent their insolvency will soon likely exceed any continued draw upon taxpayer resources. Draws on the Treasury are likely to end as the credit quality of the GSEs' assets continue to improve and credit losses decline, while dividend payments may continue. Shutting down the GSEs' ability to continue to operate during a transition will thus limit their ability to pay the taxpayers in the form of 10 percent dividends, leaving a larger ultimate bailout cost than would otherwise be the case.

Another proposal to rapidly liquidate the GSEs' portfolios could also have the unintended effect of reducing recoveries for taxpayers. The basic laws of supply and demand tell us that when entities the size of the GSEs put a large number of assets on the market at once, particularly in a soft market, prices will fall. Holding these assets for the markets to recover and selling them gradually into the markets over time is far more likely to maximize recoveries. Patience is likely to be rewarded in this case. In addition, the gradual process is less likely to depress asset values for other institutions that hold significant loan and property assets on their book, including financial institutions that we need to be healthy to continue to provide credit to support the nation's recovery.

As the Chairman himself noted in remarks in Orlando earlier this week, there are most certainly many private investors who would be eager to purchase the many good assets in the GSE portfolios. But selling these assets rapidly at firesale prices will simply allow private investors to profit from market recovery rather than the taxpayers. A more gradual liquidation strategy that maximizes returns could be used to support GSE repayment of taxpayer infusions, whether in their current form or under some transition plan to a new housing finance system.

This is NOT to argue for the current GSEs' continuation in perpetuity. I simply am arguing that we must ensure that the private market and regulators have the time needed to build the new infrastructure for private-label securitization (through reform of the mortgage-servicing industry and by providing clarity about the regulatory provisions of

QRM) and build an alternative mechanism for liquidity and affordability before ratcheting down the GSE market and liquidating their portfolios.

Unfortunately, some would argue we can take these steps without putting in place an alternative system because a fully private market, with no government backstop, is the overall desired outcome. n the final section of my testimony below, let me describe some of the potential consequences of simple privatization without ensuring we have ways to achieve the goals for American families and the economy that I set out at top.

Consequences for families and the economy of radical privatization

Some argue that we should be on a path toward no governmental role in the housing market. Rather than design a better, more targeted, government backstop that stands behind private capital—in which the government is paid for the benefit it brings to ensure liquidity and balance—these proposals argue we should instead simply take the government out of housing finance. These radical privatization proposals would present as extreme a change in the housing finance system as we have witnessed since the 1930s. And, I fear, it would leave the U.S. economy vulnerable to the kind of boom-bust cycle that we saw back then and again in the last decade thanks to unfettered private market forces.

What would American housing markets look like under a system where the government plays no role in the conventional mortgage markets?

The honest answer to this question is that nobody knows for certain because there is not a single example of a purely private mortgage system in any advanced economy. In fact, it is hard to believe we could get there ourselves. In the event that purely private intermediaries were able to finance the more than $10 trillion in mortgage debt outstanding, it is difficult to understand how their obligations would not be considered systemically important. This is particularly true given the high degree of concentration in U.S. mortgage activity (origination, servicing) and financial risk. So instead, we might create a new set of implicit, unmonitored, and unpriced government guarantees.

Advocates of a "purely private" mortgage system cite taxpayer protection and moral hazard as the primary reasons for adopting their proposal, but this analysis falls short. A "purely private" system would greatly increase the risk of taxpayer losses and would drastically increase the significant problem of socialized losses and privatized gains that had been cited as a shortcoming of the Fannie Mae/Freddie Mac model.

The problem of unpriced implicit federal government guarantees would be exacerbated if we moved to the European covered bond model that has been suggested by many advocates of the "purely private" approach. As described in more detail below, European covered bonds encourage, and to a large extent are inextricably based on, "too big to fail" institutions and implicit government guarantees. So while we might not achieve a purely

privatized system, protection for taxpayers, and avoidance of direct moral hazard, we would have some very stark consequences for American households:

- Availability of mortgage finance would be sharply reduced, with many more middle-income households shut out of homeownership.
- To the extent that mortgage finance remained available for working households, it would be directed into loans with features that were advantageous to lenders and highly disadvantageous for consumers: mortgages with shorter durations, higher costs, and very high down payments. Products that help families to fix their housing costs over time, like the 30-year fixed-rate mortgage, would not be available at prices affordable to most families.
- These problems with mortgage finance would also strongly impact the availability and cost of rental housing—even as they created a much greater demand for rental units. Rental demand is already expected to be high due to strong demographic and economic trends (in particular, the transition into adulthood for the "Echo Boom" generation, the transition into retirement for the "Baby Boom" generation, and the continuing fallout from the 2000s foreclosure crisis.
- A key strategy by which working families saved a portion of their income ("forced savings") in their homes would be less available. This option, a hallmark of the New Deal-era reforms and a pillar of the socioeconomic mobility that has characterized the American economy until recently, would be lost—and with it a part of the American Dream.

Some advocates of the "purely private" model of housing finance point to pricing in the jumbo mortgage markets, or the availability of 30-year fixed-rate mortgages in the jumbo markets, as evidence that private capital can capably serve the broader needs of American mortgage finance. This argument is inappropriate. No one disputes the idea that the "purely private" portion of mortgage system can capably serve the needs of the wealthiest Americans, just as it has always done. But the evidence—including during the 2000s, when the "purely private" part of the market briefly expanded to 38 percent of all outstanding mortgages, with disastrous results—strongly indicates that this portion of the market cannot be relied upon to serve the broader market, and certainly not if we value the origination of sustainable mortgages or the stability of the financial system.

Let us explore some of the premises underlying this prediction.

Other advanced capital economies all provide significant levels of support to their mortgage markets

The closest comparison to the United States is Canada, which provides explicit government guarantees for as much as 70 percent of its outstanding mortgages through a mixture of explicitly guaranteed mortgage insurance and explicitly guaranteed mortgage securitization.[1] Looking outside of North America, it is clear that every advanced economy in the world features significant levels of government support for its mortgage finance.

While some claim that many developed European countries don't explicitly support their mortgage markets[2], this analysis ignores the extent to which these countries provide significant implicit support to their markets. The close relationship between financial institutions and the state, which means many European financial institutions are thought to be "too big to fail," has led to a broad assumption among investors that European financial intermediaries enjoy an implicit government guarantee. As one European Central Bank official reportedly said, "We don't let banks fail. We don't even let dry cleaners fail."[3]

The idea that European mortgage finance enjoys implicit government guarantees is reinforced by the recent bailouts that have occurred since the 2008 financial crisis. In fact, Germany, Italy and Denmark provided blanket guarantees for their banking systems, and Germany, the United Kingdom, Ireland and Belgium nationalized failing banks.

This implicit guarantee is typically factored into the credit ratings of European financial institutions and their securities.[4] Finally, as discussed in greater detail below, investors appear to view the implicit guarantee, at least for covered bonds—the largest and most important source of mortgage finance for the advanced European economies—as being roughly similar to the implied guarantee provided by the United States government to Fannie and Freddie, prior to the conservatorship of these entities.

The pre-New Deal era provides us with an idea of what a "purely private" mortgage market would look like

Why does every advanced economy support its mortgage market, given all the problems created by government support? The answer to this question appears to be found in our historical experience with purely private mortgage markets.

Prior to the New Deal-era housing and banking reforms, "purely private" financial institutions dominated the markets because there were no government guarantees. By modern standards, this system was unacceptable. Mortgage finance was largely unavailable, except to the very wealthy, and the home loans that existed had terms that would be considered predatory today—high interest rates, short durations of 3-to-5 years, interest-only, a floating interest rate, and featuring "bullet" payments of principal at term (unless borrowers could refinance these loans when they came due, they would have to pay off the outstanding loan balance). Mortgages during this period also required very high down payments, typically 50 percent or more of the property value.[5]

In other words, and perhaps unsurprisingly, when private mortgage intermediaries dominated the market, they sought to originate loans that had a high rate of return, shorter time commitments of capital, and terms that protected their principal in the event of a default. In short, when private lenders had the power to dictate the market, they sought as much as possible to lay off risk and maximize returns. Despite a much smaller scale of finance, this system was also excessively volatile, leading to financial bubble-bust cycles every few years that were highly detrimental to economic growth.

The high cost, limited availability, and high volatility of pre-New Deal mortgage finance meant that homeownership was effectively limited to the wealthy. This problem was exacerbated by similarly high cost, high volatility, and limited availability rental housing finance.

The brief dominance of “private-label securitization” also provides us with an idea of what a “purely private” market might look like

The problems we experienced during the pre-New Deal era, when purely private intermediaries dominated the mortgage market, were briefly revisited in this last decade, when purely private intermediaries again, if briefly, dominated the mortgage market, growing tremendously from roughly 10 percent of all mortgage originations in 2003 to nearly 40 percent in 2006. As during the pre-New Deal era, this brief surge in the market share of purely private intermediaries was characterized by high cost products that were originated on highly lender-friendly terms.

The commercial real estate market provides additional evidence of what a “purely private” market might look like

The commercial real estate market, which is very close to the purely private market many are calling for today, resembles in many important ways the residential real estate markets of the pre-New Deal era, with relatively low loan-to-value ratios, high interest rates, interest-only (or similarly low amortization of principal), and short durations being the norm.

Commercial real estate also is extremely volatile, having gone through multiple boom-bust cycles, including one that mirrors the residential real estate boom-bust of the previous decade. Some analysts warn that the commercial real estate market, despite being only 1/3 the size of the residential market, could suffer losses from this most recent cycle that are ultimately larger than those in residential real estate..

Liquidity is likely to be lacking, particularly for consumer-friendly products such as the 30-year fixed rate mortgage

Based on these experiences, it is likely that mortgage liquidity will be severely curtailed in a purely private system. Moreover, with continued problems in private securitization and the unwillingness of insured depository institutions to take on large amounts of interest rate risk by holding too many 30-year mortgages in their own portfolios, it is difficult to imagine how the liquidity needs currently filled by the GSEs would be filled by the purely private segment of the market.

Covered bonds, while potentially a small piece of a reformed system, have severe limitations as a replacement

Some suggest that covered bonds may be the answer to this vexing liquidity problem. Covered bonds are a key source of mortgage financing in Europe. As the European Central Bank has described, "The covered bond market is the most important privately issued bond segment in Europe's capital markets."[6] In Denmark, the only other country where the 30-year fixed-rate mortgage is broadly available, mortgages are primarily financed through covered bonds.

While covered bonds might be an interesting financing option in a future mortgage finance system, they carry their own problems if issued in the United States. First, covered bonds remain on lenders' balance sheets, which means that unlike mortgage-backed securities, the mortgage loans used as collateral must still have capital held against them. For European banks, which may have difficulty securing alternative sources of funding, covered bonds are nonetheless attractive. But for U.S. banks, which already enjoy access to liquid funds through FDIC-insured deposits, covered bonds are less attractive. This is one reason why there has been such a dearth of covered bond issuances in the United States.

Second, covered bonds require a first lien on the assets that secure them, senior to all other rights, in order to achieve high credit ratings. This lien must be superior even to the FDIC's deposit insurance fund. As such, covered bonds create additional risk to taxpayers because they may prevent the FDIC from recovering a bank's best assets in the event of insolvency. Should covered bonds ever achieve a large scale (such as funding any significant portion of the $10 trillion U.S. mortgage market), they would dramatically increase the risk of loss to the FDIC, and thus the taxpayer.

Finally, the success of European covered bonds appears integrally connected to implied guarantees and "too big to fail." Because covered bonds are a hybrid between mortgage-backed securities and corporate debt, the issuer's credit rating is an important factor in attaining the investment grade rating that makes covered bonds attractive to investors. As such, they are not an appropriate funding mechanism for smaller financial institutions, and tend to work best for very large banks that are considered "too big to fail." Should the United States manage to implement a legal and regulatory framework that allowed covered bonds achieve any scale in the United States, it would encourage more consolidation in the financial sector and create more "too-big-to-fail" entities.

Based on the spreads between covered bonds and their European issuer country's sovereign debt, investors view covered bonds as enjoying a similar government guarantee as Fannie and Freddie did. For example, a 2005 survey by the Mortgage Insurance Trade Association and Mercer Oliver Wyman found that in advanced European economies, the spreads between covered bonds and risk free government debt ranged between 10-to-15 basis points.[7] This is less than the spread between mortgage-backed securities issued by Fannie and Freddie and U.S. Treasuries.[8] In other words, investors appeared to view

European covered bonds as enjoying a similar government guarantee as they did for Fannie and Freddie.

In short, the proposal to “fully privatize” the U.S. mortgage markets would essentially recreate the private-label securities market we just experienced, but on a larger scale, and the covered-bond alternative is unworkable. This learns the wrong lessons from the GSEs. The history of the GSEs teaches us that we must avoid implicit, ill-defined and unpaid guarantees not recreate them in spades.

Conclusion

These are complicated issues. We all, myself included, tend to express our views in abstract terms about what markets will do. But at the end of the day what is at stake is how American families live and save for the future. Do those not ready for homeownership have decent, safe and affordable places to live and raise their families? Do those that are ready for it have a chance to be homeowners and invest in creating a place that suits their family? Do they have a stake in their community? Do all American families regardless of where they live have a chance to save and build wealth and use it to create new opportunities for their future, as our wealthiest Americans have always been able to do?

We all know that we are living through one of the most trying and uncertain times for American families. They are far more exposed to economic volatility than they have been in 80 years. Their jobs come and go, wages rise and fall, benefits mostly fall, and retirement savings dwindle. Few believe that their children face a brighter future. Whether owned or rented, for humankind home is a refuge, a base providing the core security upon which risks can be taken and opportunities made. But now, more than in many decades, home too often is a source of insecurity, volatility, and risk.

As we move forward, we must bring private capital back into the mortgage market place and we must minimize the taxpayers’ exposure to risk. But we also must try to put people and families and home back into the conversation about housing finance reform.

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Endnotes

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