How to Reform Mortgage Finance

Conference on the GSEs, Housing & the Economy

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“The shapers of the American mortgage finance system hoped to achieve the security of government ownership, the integrity of local banking and the ingenuity of Wall Street. Instead they got the ingenuity of government, the security of local banking and the integrity of Wall Street.”

- David Frum (columnist, and former speechwriter for President George W. Bush), National Post, July 11, 2008
Overriding Principle of Reform

Economics is clear on regulation – regulate when there is a market failure.

What, exactly, is the market failure in mortgage finance that justifies government intervention?

The purpose of these entities should be to remedy a clearly identified market failure, or, in other words, fill in where markets do not exist or are unlikely to achieve socially efficient outcomes.
Major Problems w/ Mortgage Finance

- The market failure of the financial crisis is that financial institutions produce systemic risk but do not bear the costs of that risk – **negative externality**.
  
  - Systemic risk of the GSEs: $3.5 trillion in mortgage insurance, $2 trillion in OTC derivatives, $1.5 trillion in MBS (20% of which was non-prime) leading to fire sales, 1/3rd of $1.8 trillion in debt short-term (subject to rollover risk) and 1/4th of their debt was held by the banking sector with implications for bank runs, and then there is the impact on US sovereign debt with $1.5 trillion less than one year.
Major Problems w/ Mortgage Finance Continued...

- Three amplifying factors:
  - Obvious one – “implicit” government guarantee of GSE debt and GSE MBS guarantees.
  - Capital regulatory arbitrage.
  - Guaranteed to fail because of the increasing riskiness of their underlying mortgages (after 1992 Act).
How to Reform the System

- The goal of reforming housing finance is to ensure an efficient mortgage market, both in primary (origination) as well as in secondary mortgage markets.
- We have in mind a housing finance system that
  - corrects any market failures if they exist; notably in this case is the externality from undertaking too much credit and interest rate risk as this risk is inherently systemic in nature;
  - maintains a level-playing field between the different financial players in the mortgage market to limit a concentrated build-up of systemic risk; and,
  - does not engender moral hazard issues in mortgage origination and securitization; features market pricing of risks as well as charging of implicit or explicit government guarantees.
#1: Discontinue the Investment Function

- The rationale for the retained portfolio - to promote liquidity in the secondary mortgage market – does not pass our “principles” test.

- The real question is how to unwind $1.7 trillion portfolio and gradually reduce new loan purchases to zero.
#2 Restructure GSE Guarantees

- The second main function of the GSEs is to guarantee the credit risk in the mortgage loans that are bundled and sold off as mortgage-backed securities to the public.

- What are the arguments for continued government guarantees?
  - Argument #1: Put aside the regulatory arbitrage discussion earlier, and the fact that no other country has a system like this, the most efficient mortgage finance system involves securitization.
#2 The Economic Model of Securitization

- Putting “skin in the game” and “loan renegotiations” aside, securitization turns lead into gold:
  Illiquid loans pooled together to form securities traded on an active secondary market
- Expand credit & risk sharing
  Transfer some of the credit risk out of banking sector to capital market at large
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- Argument #2: The “genie in the bottle” problem
#2 “Genie in the Bottle”

- Does a successful securitization mortgage market require government guarantees?
  - 25 years of capital markets have developed to be reliant on guarantees

- Can the private market provide these guarantees?
  - Private sector is capable though currently crowded out. Based on our criteria, rids the system of distortions, but …
  - Can the market for mortgage finance be truly “private”? According to a Fed Res Bank of Richmond study, is it really a level playing field when 58% of liabilities now under safety net?

- Been there, done that feel to it. Systemic risk buildup.
  - Example: leading up to the crisis, $960 bn of PMI, 80% of which was performed by 6 companies. In 2007, they lost 60% mkt value; need much better capitalization.
#2 Nationalization/Public Utility Model

- Nationalization – gov’t run utility like GNMA
  - On the positive side, *maybe* reduces systemic risk; collect actuarial fees for guarantees
  - On the negative side,
    - Is there any evidence that the gov’t can price the guarantees?
    - Poor governance and lack of accountability
    - Is this the balance sheet we want for the U.S. government?
#2 Our Preferred Plan – Hybrid Solution

- Balance the enhanced liquidity for the mortgage market that guarantees provide against the difficulty in pricing these guarantees and the resulting lack of market discipline against buildup of systemic risk.

- Private-public partnership (precedent with 2002 TRIA)
  - Private sector provides insurance establishing a market price – important
    - Liquidity price is low, but mortgage rates will reflect market & credit risk
    - Private markets won’t be crowded out, allowing less gov’t involvement over time

- Too much capital to provide such systemic insurance, so most of the insurance would be purchased from the government.
  - Need enough private insurance to price market, not too much to be systemic.
  - Gov’t would have to be written into law as a “silent” partner.
#2 Our Preferred Plan Continued...

- Credible resolution authority for private insurers – be well (but not fully) capitalized. Upon failure, MBS guarantees of private insurers (albeit limited) would be pari passu with unsecured debt.
  - If PMI held within a larger firm, would need to be ring fenced.
  - Capital requirement rules would need to be set to avoid the type of regulatory arbitrage that took place.
- Contrasts with other proposals that want the government to provide “tail risk” insurance.
  - Our plan prices guarantees in private markets, whereas government “tail risk” relies on government pricing
  - In our plan, while the private sector controls quantity of the risk creation, it also bears the risks; so there is a good alignment of incentives. With tail risk, the private sector controls quantity of tail risk borne by the government! And if tail risk transpires, the private sector is wiped out – is that systemic?
- Our goal is to reduce the role of government over time so …
  - Only conforming, safe mortgages are backed (like old GSEs)
  - One idea is to reduce conforming limit over time
#2 What About Non-conforming Mortgages?

- Almost 50% of current market is nonconforming.
- Private-Public partnership could help, but what if the market prices it wrong?
- Leave to the private market
  - Higher capital requirements, concentration limits, or a systemic risk “tax” to limit systemic risk buildup
  - Leverage requirements at asset level
  - Credible resolution authority
#3 The Role of Homeownership

- CBO estimates approximately $300 billion worth of subsidies to housing and mortgage markets.
  - Massive overconsumption in housing. Is real estate investment as productive investment in business capital or human capital?
- And in terms of supporting low income housing, studies find that the GSEs represent a wealth transfer more to the well-to-do than the poor.
- And is homeownership even socially optimal? But if it is, GSE-like entities are very indirect way of doing this.