"INFORMATION AND THE MORTGAGE CRISIS"

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"THE FUTURE OF HOUSING FINANCE –
A REVIEW OF PROPOSALS TO ADDRESS MARKET
STRUCTURE AND TRANSITION"

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Chairman Frank, Ranking Member Bachus, and other distinguished members of the Committee:

Thank you for the invitation to testify at today's hearing on the "The Future of Housing Finance – A Review of Proposals to Address Market Structure and Transition." It is my honor to be here today to discuss the principles and proposals of various stakeholders related to reform of the housing finance system, as well as the Dodd-Frank Act's implications for the mortgage and securitization markets.

Title XIV of the Dodd-Frank Act is the first step in regulating mortgage origination and securitization, but it is only a beginning. It requires the securitizer to retain at least 5% of the default risk of the underlying assets, but it exempts "qualified residential mortgages" from this regulation. This is a loophole, but even mortgages that do not meet this standard can put the system at risk. 5% risk retention is not a panacea.

The U.S. housing finance market suffers from market failure that will require reform. It is important to understand that the explosive growth of nonstandard mortgages (including adjustable teaser rates, balloon payments, and lax lending standards) and private-label securitization (PLS) was a supply-side phenomenon. The housing bubble was exacerbated by but did not result from greater demand for homes in the face of inelastic supply. Yes, low interest rates, affordable housing policies, local land use regulations, and irrational expectations all contributed to price appreciation, but none of these factors was the primary cause. Instead, it was securitizers' appetite for mortgage-backed securities (MBS) that drove a "race to the bottom" in lending standards, risk creation, and competition for market share.

The proof of this culprit's guilt is the declining spread of MBS over Treasuries in parallel with the rise in nonstandard mortgages and PLS. We now know that Wall Street was securitizing increasingly risky mortgages—that is, with high expected default rates. The securitizers should have been paying investors higher interest rates to compensate them for bearing higher default risk. What actually happened was the opposite: Securitizers sold riskier MBS while paying lower interest rates (even in comparison to the low rates generated by Federal Reserve policies).

The only way that investors would accept such a bad deal is if they did not realize that they were bearing higher default risk. As my recent research with Georgetown professor Adam Levitin demonstrates, that is exactly what happened. The modern housing finance market suffers from asymmetric information. Borrowers and originators (and even securitizers) have much better knowledge about the risk of underlying assets than the investors who end up with them. Specifically, PLS became increasingly complex, and the mortgages became increasingly heterogeneous. Investors have difficulty computing risk for complex and heterogeneous assets. As lenders came to rely on nonstandard mortgages with more variable features, investors became less accurate in assessing each mortgage's risk, let alone the risk of an entire mortgage pool that has been securitized. As my recent research with Simon Frasier University professor Andrey Pavlov demonstrates, the underpricing of risk masked the fact that the capital cushions were really "fake equity" reliant on unsustainable lending standards. When prices fell, that lending disappeared, and equity shrank.

At this time, I request that the two papers referred to the in the previous paragraph be entered into the formal record.

Securitizers took advantage of this blind spot for six reasons. First, traders were compensated with a fee for each product sold, encouraging production and not the long run quality of product. Second, the executives monitoring them were compensated with bonuses that emphasized short-term gain over long-term risk. Third, capital requirements were lower for MBS than many other, less risky assets and effectively decreased with growing leverage over time. Fourth, the rating agencies had the same blind spot as the investors, ignoring the increasing risk of the mortgage pools. Fifth, past government actions gave the securitizers reason to believe that they were "too big to fail." Sixth, these firms hedged much of their default risk with credit default swaps, encouraging them to take more risk. These six factors motivated securitizers to produce as many MBS as possible, which required lower interest rates *and* riskier mortgages.

The Dodd-Frank Act attempts to remedy some, but certainly not all, of these problems. It is clear that the 5% risk retention requirement, while it may make securitizers less likely to increase the riskiness of the mortgage pools, cannot prevent the phenomenon from recurring. Many of the most fragile banks retained far more than 5% of the default risk of the mortgage pools that they securitized. This risk did not stop them from leading the race toward nonstandard mortgages and PLS. Even if the requirement does have the desired incentive effect, however, securitizers will still have difficulty assessing the risk of complex and heterogeneous products, as will investors. They will still agree to low interest rates for high risk when the market is growing, their competition is gaining, and they cannot understand the details of the products or compute the expected default rate of the overall pool.

A more sustainable solution is to move the market toward greater transparency and standardization in the secondary market for mortgage securities. Regulators must encourage originators to issue standard mortgages, for the securitization market, and they must discourage securitizers from bundling complex and heterogeneous products. These considerations are imperative to the transition from the current conservatorship of Fannie Mae and Freddie Mac (the "government-sponsored enterprises," or GSEs) to a new arrangement.

We must ensure that the GSEs remain in their conservatorship for the near future. They own or guarantee more than half the mortgage market, $5 trillion, and they support almost all of new transactions. Without conservatorship, housing prices would have fallen farther and faster, undermining consumer confidence and the balance sheet of the banking sector: unemployment would be higher, and a double dip in housing markets and the economy could not be ruled out, with foreclosures feeding price declines in a reinforcing downward spiral. If Congress wishes this still fragile recovery to build strength and unemployment to fall, they must not terminate the conservatorship until the market stabilizes—an event which may still be a few years away.

Any reform of the GSEs must go hand-in-hand with stricter regulation of PLS. When the government designates "qualified residential mortgages," investors will expect these products to be safe and will be less likely to investigate their risk profile. Reform of the GSEs may involve a similar problem, as any mortgage that receives some form of government support will also be considered "too big to fail." These designations increase moral hazard and thus systemic risk. "Qualified" must therefore be a very strict designation, as must any explicit government support.

We know from experience, however, that there will be great pressure on future regulators to loosen these standards when the market is thriving. Regulators must therefore require originators and securitizers to inform investors of relevant terms of each loan, as well as other risk-related information. Most importantly, in order for the information to be analyzed, the information that is required must be standardized and the information must be vetted.

Another lesson of the recent bubble and crisis is that it is not enough for investors to understand the products they are purchasing. They must also have better information about the rest of the market, as the other products affect the performance of the mortgages in their pool.

Transparency is not enough. Even with all the information, some products are simply too complex and heterogeneous for investors to assess properly. The Dodd-Frank Act enforces stricter lending standards, but it does less to restrict the products that can be securitized. Securitization offers a very specific benefit to securitizers: It increases the liquidity and profitability of the underlying assets. Therefore, it should only be available to products whose risk can be analyzed. Securitization of nonstandard mortgages and the opacity this creates, as we have seen, increases systemic risk. The resulting "tail risk" is owned by the taxpayer. To avoid the generation of tail risk that is owned by the taxpayer, regulators must adopt stricter standards about information that must accompany the issuance of mortgage backed securities (MBS). Investors and regulators must be in a position to monitor standards in the book of MBS business as they are being generated both to price these risks effectively and to require increased capital if that becomes necessary.

There are several promising options for reform of the GSEs themselves, but any arrangement should limit the level of risk borne by the taxpayers. We must remember the reason the GSEs exist in the first place. Without government support, the long-term, fixed-rate mortgage would not be the dominant form of housing finance in the United States, as the experience of other countries can confirm. We must not lose this centerpiece. Short-term, adjustable-rate mortgages place the interest rate risk on the borrowing household, resulting in mounting defaults, when there is a mortgage rate shock or seizing up of financial markets, as we have seen over the past few years.

One solution, proposed by the MFWG group of the Center for American Progress, is for the government to sell an insurance "wrap" to licensed mortgage issuers that guarantees the underlying mortgage, for standard MBS. Unlike the previous GSEs, this arrangement makes the government support explicit, but the government, not the issuer, receives the interest payments. Another option, proposed in great detail by economists at the Federal Reserve Bank of New York, is to group mortgage originators into cooperatives that purchase and securitize the mortgages of their respective members. The disadvantage for this proposal if taken in isolation is that originators may not join the coops if they are not profitable enough (in other words, the coops would be crowded out by PLS).

In truth, both options are open to "crowding out," the very phenomenon that spelled the GSEs' demise. If PLS can be more profitable using nonstandard mortgages, then originators will flock to the private securitizers, leaving the government wrap or coops in the dust. Both options, as well as the possibility of a return to the original GSE status with an explicit guarantee of MBS (and perhaps a limited or eliminated MBS portfolio), have great promise, but they all will require significant regulation of private activity to succeed.

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