THE U.S. HOUSING FINANCE SYSTEM IN THE GLOBAL CONTEXT: STRUCTURE, CAPITAL SOURCES, AND HOUSING DYNAMICS

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U.S. HOUSING FINANCE SYSTEM IN THE GLOBAL CONTEXT: STRUCTURE, CAPITAL SOURCES, AND HOUSING DYNAMICS

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PREPARED STATEMENT OF SUSAN M. WACHTER

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Chairman Miller, Ranking Member McCarthy, and other distinguished Members of the Committee, thank you for the invitation to testify at today's hearing on the ``U.S. Housing Finance System in the Global Context.'' It is my honor to be here to discuss the relationship between the US housing finance system and global financial stability, how the US mortgage market structure differs from other countries in terms of the securitization system and mortgage products, the benefits and weaknesses of unique features of housing finance in the US, and foreign involvement in the housing finance system, specifically the motivations of foreign investors in purchasing residential mortgage-backed securities.

The US housing finance system relies on global capital sources for funding. The mortgage related bond market as of the second quarter 2011 amounts to approximately $7 trillion, most of which today is securitized and guaranteed by the US government. As the subprime crisis demonstrated, disruptions in US mortgage system destabilized financial markets across the world. The structural soundness of this sector is important for US home borrowers, the US economy, and for overall global financial stability.

The US housing finance system, prior to the crisis, was financially sound. The system prevalent in the US provided US home buyers, unlike buyers elsewhere, a choice of fixed and variable rate mortgage product and provided financial stability for mortgage borrowers and for global capital markets. The unique features of housing finance in the US which undergird this system include access to stable long term fixed rate mortgages and the financing of these mortgages funded by a sound securitization system.

The long term fixed rate mortgage prevalent in the US, what Richard Green and I term the American mortgage, is unique to the US. In most developed countries, with few exceptions, the adjustable rate mortgage prevails. The fixed rate pre-payable mortgage, with the ability to lock-in financing at the point of home selection, is found solely in the US. While adjustable rate mortgages are a good and safe alternative to fixed rate mortgages in periods of stable or declining interest rates, the weakness of such mortgages is that they threaten borrowers with payment shock when interest rates rise. Shocks to households' balance sheets due to rising interest rates or limited availability of finance threaten the financial system as a whole. Indeed versions of this scenario played out in the subprime crisis and the Great Depression.

The US mortgage system also differs from most of our developed country peers in the use of securitization as opposed to the holding of mortgages in bank portfolios. In research with co-author Adam Levitin, we show why the fixed rate mortgage requires securitization. Securitization first arose out of the need to replace the short term variable rate mortgage with so-called bullet payments implicated in the high foreclosure rate of the Great Depression. While the fixed rate long term self-amortizing mortgage developed in the aftermath of the Great Depression protects borrowers against interest rate spikes, as shown by the savings and loan crisis, short term demand deposits cannot be relied upon to fund long term mortgages. Securitization is a necessary replacement for demand deposit based bank portfolios. The system of fixed rate mortgages financed through stable securitization provided for a period of remarkable stability in the US economy, coinciding with what has been termed the Great Moderation, a period of economic growth, strong and sustainable homeownership, uniform and intrinsically safe underwriting practices, and importantly for the Committee, the ability to access global capital markets.

This system underwent major shifts beginning in 2000. The changes over the subsequent decade caused the system to fail, threatening global financial stability with outcomes that still threaten the US economy. In the period 2000 to 2006, nontraditional mortgages, previously niche products, such as adjustable rate teasers, subprime, interest only with bullet payments, grew to represent, in 2006, almost half of mortgage originations.

The origin of the mortgage system failure was credit expansion through private label securitization accompanied by the undermining of lending standards, despite the Triple-A credit rating granted for much of the MBS debt. Global capital funded this expansion in part relying on credit ratings. Fannie and Freddie market share at first was eroded by the expansion of PLS but then these institutions themselves funded risky MBS and extended and deepened the subsequent crisis. Foreign investors purchase residential mortgage-backed securities guaranteed by Fannie Mae and Freddie Mac and they do so because these instruments are perceived to have essentially no credit risk; the PLS similarly were understood to have little or no risk in part due to high credit rating scores and in part because the US mortgage and housing market were perceived to be impervious to declines. The expansion of credit that this perception allowed and the deterioration in lending standards fueled the price bubble with a bust when the limits to lending expansion were reached accompanied by the epidemic of foreclosures and value destruction that we are currently facing.

Failure in the US mortgage system directly caused the 2009 recession. We were not alone in this. The United Kingdom, Spain, and Ireland suffered recessions accompanied by mortgage market crises and sharp housing price declines. Nonetheless, the size of the US market means that it relies on global finance and the failure of the US housing finance system put the global finance system at risk. The response in the US of the bailouts of failing financial institutions and the conservatorship of Fannie Mae and Freddie Mac is ongoing. Private securitization has not come back and for now we are now reliant on a federalized system. Elsewhere we discuss the necessity of long term reforms. The key going forward is rebuilding confidence in the US mortgage system. This is necessary for potential home buyers to come back to the market and it is also key for global investors on whom this market depends to provide capital for what once again must be perceived to be and must be a system that structurally sound and safe for home purchasers, investors and the overall economy.

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United States House of Representatives
Committee on Financial Services

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