"THE FINANCIAL CRISIS AND THE ROLE OF THE GSES"

Testimony prepared for

"FANNIE MAE AND FREDDIE MAC: HOW GOVERNMENT HOUSING POLICY FAILED HOMEOWNERS AND TAXPAYERS AND LED TO THE FINANCIAL CRISIS"

ON

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BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT-SPONSORED ENTERPRISES

U.S. HOUSE OF REPRESENTATIVES

WRITTEN TESTIMONY
SUSAN M. WACHTER
Richard B. Worley Professor of Financial Management
Professor of Real Estate and Finance
The Wharton School
University of Pennsylvania

3733 Spruce Street
430 Vance Hall
Philadelphia, PA 19104

Chairman Hensarling, Ranking Member Waters, and other distinguished members of the Subcommittee:

Thank you for the invitation to testify at today's hearing on "Fannie Mae and Freddie Mac: How Government Housing Policy Failed Homeowners and Taxpayers and Led to the Financial Crisis." I am the Richard B. Worley Professor of Financial Management at The Wharton School of the University of Pennsylvania. Together with co-authors, I have researched and written scholarly papers on the GSEs and the mortgage crisis. Recent publications are listed at the end of this statement. It is an honor to be here today to discuss a critical issue for the future of the housing finance system, that is, the role of Fannie Mae and Freddie Mac in the financial crisis.

Government housing policy failed homeowners and taxpayers and it is important to understand why. The GSEs contributed to the meltdown. The direct cause of the crisis was the proliferation of poorly underwritten and risky mortgage products. The majority of these products, and the most risky products, were funded through private label securitization.

We know now but did not know in real time the shift toward unsound lending. Nontraditional and aggressive mortgages (such as teaser rate ARMs and interest only mortgages) proliferated in the years 2003 to 2006 changing from their role as small niche products to become nearly 50% of the origination market at the height of the bubble in 2006. In particular, the extent to which the loan-to-value ratio of the underlying loans was increasing through second liens was not monitored, tracked, or known. As the market share of these products expanded, the market share of the GSEs declined, as shown in Exhibit A.

In the years that I have identified as "the housing bubble" – that is, 2003 to 2006 – the GSEs saw their market share plummet. According to the Financial Crisis Inquiry Commission (FCIC), private-label securitizers issued over 30 percent more mortgage-backed securities (MBS) than the GSEs during these boom years. As shown in Exhibit B, this dominance by private-label securitization (PLS) was a new phenomenon. It is only during the years when housing prices rose to unprecedented heights that PLS achieved this unprecedented takeover.

As non-agency private label securitization was expanding, overall leverage was increased by the creation and growth of financial derivatives, collateralized debt obligations (CDOs), CDOs squared, and CDS. The so-called B-rated pieces of MBS were re-securitized as triple-A rated CDO securities, increasing leverage. Credit default swaps were issued to insure the providers of funding to MBS, but without requiring reserves. The amount of the increasing leverage introduced by the issuance of CDOs, CDS squared, and CDS was not known. The deterioration of the quality of the mortgages used as collateral for these securities was not known. These risk sources were obscured due to the lack of consistent and transparent reporting requirements.

The rise in prices that the expansion of credit enabled initially masked the increase in credit risk. If borrowers were having trouble with payments, homes could be sold and mortgages could be refinanced, thus concealing the increases in credit risk. In mid-2006, prices peaked and mortgage delinquencies, defaults and foreclosures started their inevitable upward course. In the panic of mid- 2007, private label security issuing entities imploded and financing was no longer available: the issuance of new PLS went from $1 trillion to effectively zero.

The US economy faced the real threat of a second Great Depression. As housing prices declined, below mortgage values, forced sales through foreclosures caused prices to fall further. The resulting wealth destruction together with the freezing of finance caused the real economy to falter, leading to the recession of 2009. The recession itself brought about the so-called double trigger: households who lost their jobs could not sell their homes making ongoing foreclosures inevitable, with the potential of an outcome of a vicious downward spiral.

The housing price decline of 30%, only now being reversed, was due to this dynamic. The Federal government, the Treasury and the Federal Reserve Board policy responses supported the housing mortgage market, preventing the worst case outcome. Nonetheless, the loss of jobs, the decline in household wealth and the increase in US debt are continuing legacies of the crisis.

As I stated, the GSEs contributed to the crisis. Prior to 2007 the GSEs purchased the triple-A rated portion of MBS and they also securitized alt a loans. The GSEs were part of the irresponsible expansion of credit both before and after 2007 but other entities were far more responsible for the riskiest product originated and securitized.

There is, in fact, a simple way to measure the success or failure of the GSEs, relative to other entities. All we have to do is examine default rates. The GSEs' delinquency rates were far below those of non-GSE securitized loans. The distribution of mortgage failure is apparent in the performance of mortgages underlying securitization as shown in Exhibit C. I ask that these three Exhibits be entered into the official record.

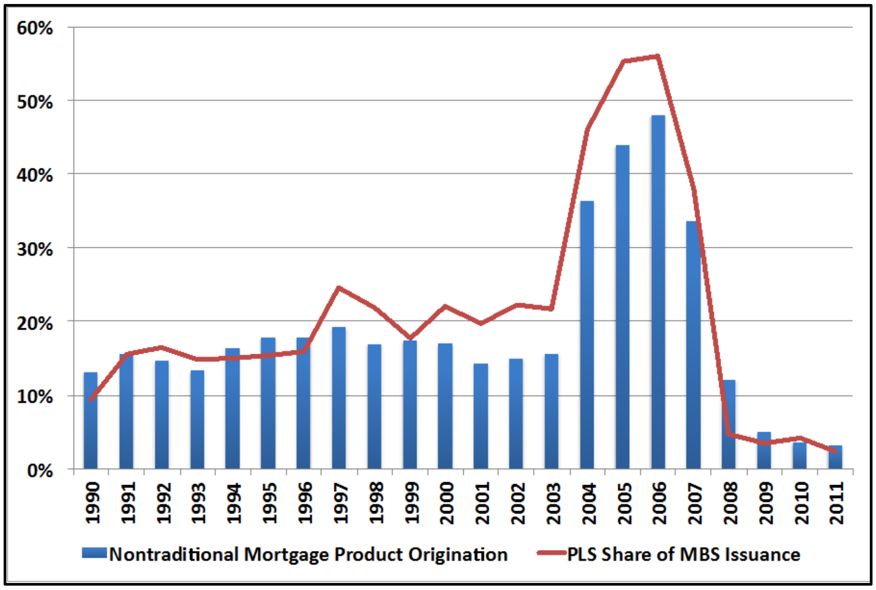
However, in a broad sense, the GSEs or their overseer may have had a larger responsibility which they failed to fulfill. The failure to identify credit and systemic risk in the markets in which they operate was at the heart of the financial crisis. No entity was looking out for the US taxpayer: Neither the Fed nor other financial regulatory agencies, nor the Treasury, nor OFHEO which at that time oversaw Fannie Mae and Freddie Mac. Financial markets did not operate to correct the growing risk. We know from this crisis and from previous crises, that markets do not self-correct in the absence of arbitrage, that is, in the absence of markets in which securities' sales can price and trade risk, and for arbitrage and market trading of securities to occur we must have market standardization and transparency.

The failure to identify credit and systemic risk is at the heart of the financial crisis and must be corrected going forward. This will require the reform of the housing finance system, in particular, to assure mortgage security standards and transparency. There must be a monitoring function to identify credit risk through the documentation and identification of risks in mortgage products and in mortgage securities. This role is a central requirement for effective markets and it requires a standardization and coordination function for its realization. This need not be performed by the GSEs or the regulator, although such a role had been theirs in the stable decades before the crisis, but the role is nonetheless a necessary one. We can rebuild a resilient housing finance system, one which can protect homeowners and the US taxpayer going forward, but in order to do so we must understand and correct the failures of the past.

I thank you for the opportunity to testify today and I welcome your questions.

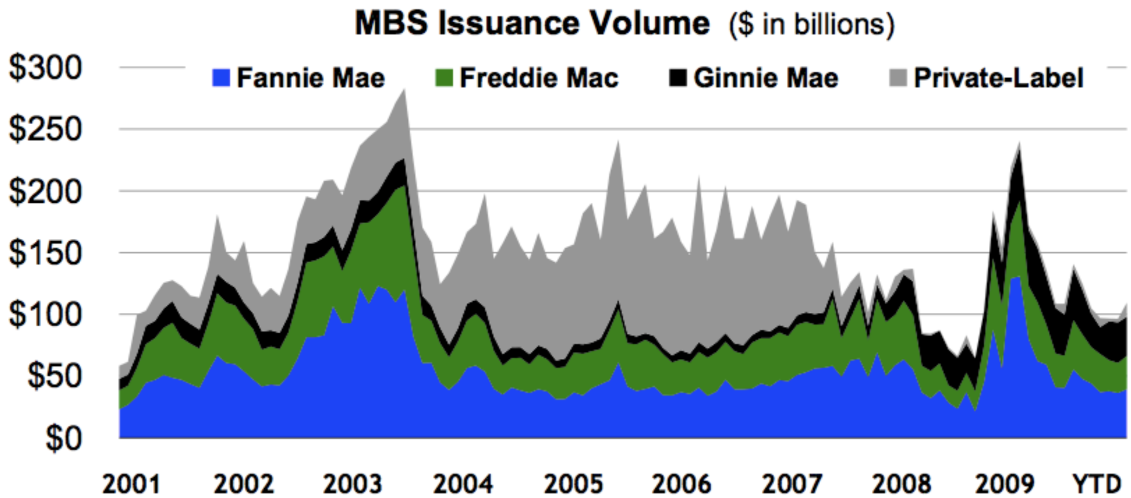
Exhibit A

Market Share of Nontraditional Mortgage Products and Private Label Securitization



Source: Inside Mortgage Finance 2012 Mortgage Market Statistical Annual. Nontraditional mortgage products are subprime, Alt-A and home equity loans.

Exhibit B

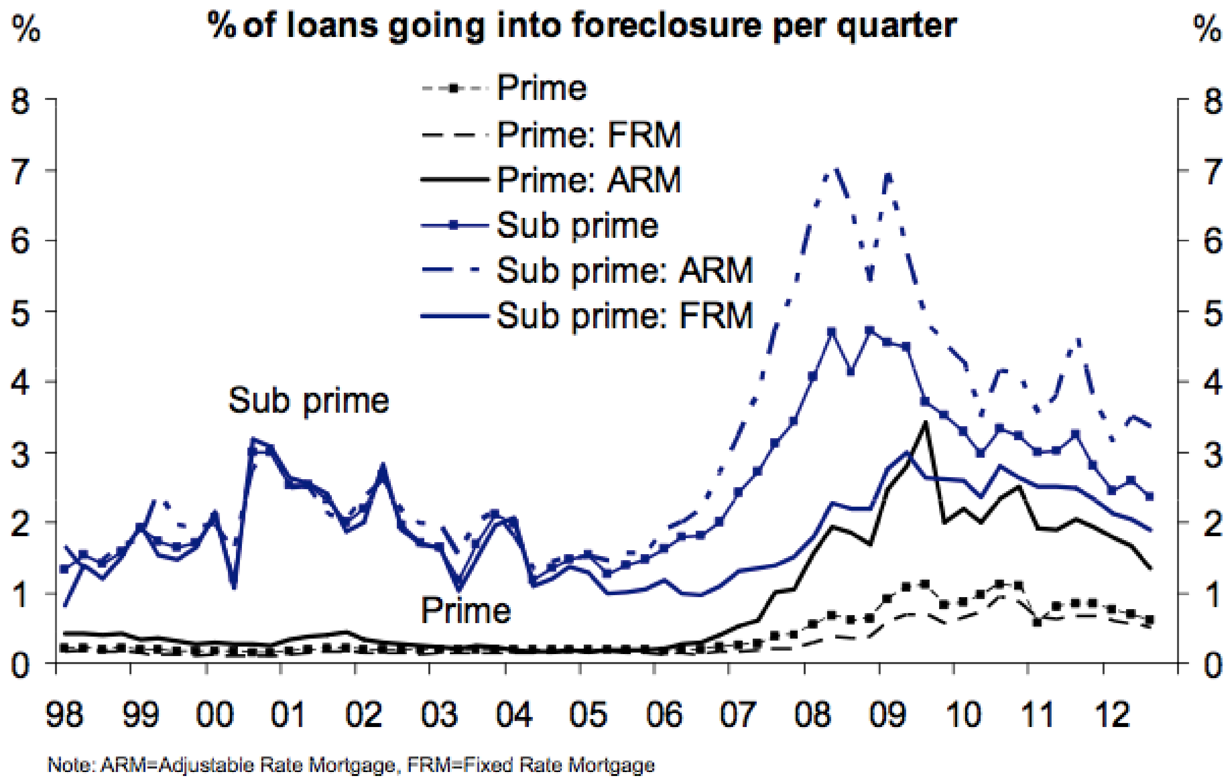


	2001	2002	2003	2004	2005	2006	2007	2008	2009	YTD
Enterprises	67%	68%	70%	47%	41%	40%	58%	73%	72%	66%
Ginnie Mae	13%	9%	8%	7%	4%	4%	5%	22%	25%	29%
Total Agency	80%	77%	78%	54%	45%	44%	63%	95%	97%	95%

Sources:
Inside Mortgage Finance, Enterprise Monthly Volume Summaries.
Issuance figures exclude MBS issued backed by assets previously held in the Enterprises' portfolios.

Source: Federal Housing Finance Agency (2010)

Exhibit C: Foreclosure by Market Segment



Source: MBA, Datastream, DB Global Markets Research

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