# Statement of Arnold Kling*

Prepared for the U.S. House Committee on Financial Services

Hearing on

Building a Sustainable Housing Finance System: Examining Regulatory Impediments to Private Investment Capital

April 24, 2013

*Arnold Kling is a member of the Financial Markets Working Group of the Mercatus Center. Views expressed here are his own.

Chairman Hensarling and ranking member Waters, thank you for the opportunity to appear today before the committee on financial services to discuss the issue of returning private capital to the housing finance system.

Let me start by admitting that my involvement with housing finance took place in the late 1980s and early 1990s. I hope that my experience with history can compensate for my lack of familiarity with current practices.

I joined Freddie Mac as a senior economist just as the Savings and Loan Crisis was reaching its final stages. Many of the solutions to the savings-and-loan crisis came back as problems in the recent debacle. Securitization was supposed to get the mortgage risk out of government guaranteed depository institutions, but instead massive bailouts were needed. Changes to accounting rules and capital regulations were intended to correct regulatory shortcomings in the 1980s, but they also proved counterproductive in the latest episode.

Today, with all of the focus on credit risk, I worry that policy makers today are paying too little attention to interest-rate risk. Just when the public is being led to expect that better regulation is the solution to financial stability, we may instead be setting the stage for the next meltdown and the next round of bailouts.

My main concern about bringing private capital back into the mortgage market is that I do **<u>not</u>** believe that the private sector has the ability to bear the risk of holding large quantities of 30-year fixed-rate mortgages. The money managers and Wall Street experts who say otherwise are the same people who assured us in 2005 and 2006 that mortgage securities backed by subprime loans posed no risk to the financial system. Instead, my warning to this committee would be that if there is a sharp rise in interest rates some time in the next decade, you can bet that taxpayers will once again be called on to bail out large financial institutions with decimated portfolios. I will elaborate on this later.

Taxpayers would be better served if more of the mortgages originated in the United States were similar to the five-year rollover instruments common in Canada today. Such a loan would have a thirty-year amortization schedule, but its interest rate adjusts to market rates every five years. Short-term adjustable-rate mortgages, such as those where rates adjust every year, are too much of a gamble for borrowers. However, the thirty-year fixed-rate mortgage is too much of a gamble for lenders. When lenders gamble, the winnings always end up in private hands and the losses usually wind up with the taxpayers. The five-year instrument is a better compromise, reducing the scope for gambling by lenders without exposing borrowers to undue risk.

I do not wish to dictate the 5-year mortgage. However, I believe that if government maintains a neutral stance between 5-year instruments and 30-year fixed-rate instruments, and it neither directly nor indirectly subsidizes investors in 30-year mortgages, then the market may very well offer 5-year loans on terms that attract borrowers.

With that said, here are some suggestions for what policy makers can do to help bring private capital back into the mortgage market.

1. **Stop** demonizing mortgage originators. It is impossible to make mortgage decisions perfectly. Sometimes, you make a reasonable decision to approve a loan, and later the borrower defaults. Sometimes, you make a reasonable decision to deny a loan, and yet the loan would have been repaid. Beyond that, good luck with home prices can make any approval seem reasonable and bad luck with

home prices can make any approval seem unreasonable. During the bubble, Congress and regulators beat up on mortgage originators to get them to be less strict. Since then, Congress and regulators have been beating up on mortgage originators to be especially strict. I expect mortgage originators to make mistakes, but the fact is that they do a better job without the "advice" that they get from you. Right now, lending institutions are cautious, because they fear being blamed for any decision that turns out badly. Mortgage credit will remain scarce until regulators clarify rules and guidelines that will allow them to make decisions without being subject to arbitrary punishment afterward.

2. **Stop** demonizing mortgage servicers. Mortgage servicing is a competitive business with low profit margins. Servicers have a lot more experience than you do in dealing with troubled loans. By insisting that they "cure" such loans in large numbers, you have greatly raised the cost of their business. Given these cost increases, the only loans anybody wants to service nowadays are loans with large down payments and very high credit scores. Just as with mortgage origination, the absence of rules and guidelines, combined with a "gotcha" mindset among regulators, is driving companies out of the mortgage servicing business and making it more difficult to obtain a loan.

3. **Start** bringing down loan the maximum loan sizes at Freddie Mac, Fannie Mae, and FHA. As the range of the public market narrows, the private market will expand.

4. **Start** developing a national automated title system using what is called the Torrens title approach. With a Torrens title, current ownership of a property is definitive, and prior claims on title are resolved with compensation that does not affect the current owner. This eliminates the need for title searches and title insurance. The current fragmented courthouse title system imposes unnecessary costs on mortgage originators, servicers, and securitizers.

5. **Start** developing a national standard for loan servicing agreements, and include recourse in the standard agreement. With recourse, a borrower with the means to repay a loan cannot just "mail in the keys." Recourse loans will discourage speculative home purchases while lowering the interest rate for genuine home buyers.

6. **Continue** to develop a national standard for a conforming mortgage loan for mortgage securities. The key factors to standardize are the minimum down payment, positive amortization, and limiting the loan purpose to owner-occupied purchase or no-cash-out refinance. On the other hand, government should not impose inflexible income ratios, debt ratios, or documentation standards.

7. **Continue** to support consumer protection, financial literacy, and programs to help families save for down payments.

Finally, I urge you to set modest objectives for housing policy. When the decision is made in Washington about whether people should own or rent, what type of mortgage they should obtain, and where the capital on that mortgage should come from, the result is to empower the lobbyists and the special interests. I am talking about the real estate agents, mortgage bankers, home builders, Wall Street firms, and community action groups that wrap themselves in the flag of what they call the American dream of home ownership. These organizations have too much power and too little shame. When policy is wide-ranging and ambitious, the special interests win and the taxpayers lose.

<u>Interest-rate Risk and Capital Markets</u>

The most popular mortgage product with consumers in the United States today is a 30-year fixed-rate mortgage with no prepayment penalty. Unfortunately, there is no class of investors for which a 30-year fixed-rate instrument that is instantly callable is a natural fit.

The private sector has never demonstrated an ability to manage a portfolio of thirty-year fixed-rate mortgages. The savings and loan industry went bankrupt in the late 1970s, because their cost of funds rose above the interest rates they were earning on the mortgages that they had originated over the previous decade.

By the 1990s, the dominant providers of thirty-year fixed-rate mortgages were Freddie Mac and Fannie Mae. However, they were not able to satisfy demand by issuing mortgage-backed securities and selling them to other institutions. Instead, their growth took place in their "retained portfolios," meaning whole loans and mortgage-backed securities financed by issuing debt. In other words, Freddie and Fannie took on the task of managing the interest-rate risk on thirty-year fixed-rate loans.

To finance their loan portfolios, Freddie and Fannie issued both ordinary bonds and callable debt. An example of callable debt might be a bond with a fixed interest rate and a stated term of 10 years but giving the agency the option to call the debt after 5 years, meaning that the debt would be paid off at par.

These debt instruments only re-distributed some of the interest-rate risk from Freddie and Fannie to private investors. Another portion of the interest-rate risk was hedged using derivatives. Even with those hedges, Freddie and Fannie retained some exposure to extreme movements in rates.

Some remarks about interest-rate risk management in the period of Freddie and Fannie growth:

1. Investors showed very little appetite for 30-year mortgages. Instead, their appetite was for straight and callable debt.

2. The use of derivatives shifted risk into what we now call the "shadow banking system." Regulators had no way of knowing where this risk was being held. Some regulators have suggested that putting derivatives on an exchange would solve this problem. However, no exchange has ever traded the sorts of derivatives that are needed for hedging 30-year mortgages. These are deep, out-of-the-money options. The writers of such options will not be able to afford to put up significant collateral up front. As the values of the options change, the exchanges will have to make margin calls on the option writers. In an environment where interest rates move dramatically, these margin calls may lead to bankruptcies among the option-writers, the exchanges, or both. There is no way to test the system ahead of time to see whether it will work.

3. In fact, the system for distributing interest-rate risk that emerged as Freddie and Fannie grew was never tested. Over the last two decades, we have not had a spike in interest rates like the one that we experienced in the 1970s. We do not know what would have happened to the derivative markets or the markets for callable debt in a stressful environment. We do not know whether Freddie Mac and Fannie Mae held adequate capital. We do not know whether the institutions that supplied out-of-the-money options in the derivatives market would have been able to meet their obligations.

What we do know is that the balance sheets of Freddie and Fannie were highly brittle, and the loss of confidence by investors in the middle of 2008 made it impossible for the two companies to continue as independent entities. Morever, no one has suggested returning to a situation in which government-sponsored enterprises support the 30-year mortgage market by issuing their own debt. The institutional replacement for the Freddie and Fannie loan portfolios has yet to be specified.

Right now, there is considerable interest-rate risk embedded in an institution that never used to have any: the Federal Reserve. Federal Reserve officials are aware of a contingency in which a rise in interest rates causes the bank's earnings to go negative. That in turn might require asking for an appropriation of funds to cover operations. The fact that the Fed is taking on interst-rate risk indicates to me how little appetite there currently exists in the private sector for such risk.

With any proposed reform of the mortgage finance system that contemplates a dominant role for thirty-year fixed-rate mortgages, the question that should be asked is: where will the interest-rate risk reside? Suppose that we experience a spike in interest rates some time in the next decade. Which institutions will incur losses, and how will they absorb those losses?

When I ask these questions of money managers, they say “Don't worry. We are the professionals. Managing risk is our business.” But such vague reassurances are unacceptable coming from an industry that just recently required massive bailouts. If we do not know precisely where the risk will go, then we cannot rule out the possibility that it will end up in government-insured banks or Systemically Important Financial Institutions (the regulators' euphemism for “too big to fail”). Indeed, *any* institution that takes on a significant share of the interest-rate risk will *become* systemically important, just as AIG Insurance became systemically important because of the significant role it played in the allocation of mortgage credit risk.

In summary, I do not believe that the thirty-year fixed-rate mortgage can be issued in large volume without taxpayers becoming liable for interest-rate risk. Conversely, if we reform the housing system so that the private sector truly bears the risk, then borrowers would encounter a large differential between the cost of a thirty-year fixed-rate mortgage and the cost of a loan with an interest rate that is fixed for only five years. Borrowers should be making their choices based on this true cost differential.