Testimony of Mark A. Calabria, Ph.D.
Director, Financial Regulation Studies, Cato Institute
Before the
House Committee on Financial Services
On "Housing Finance – What Should the New System Be Able To Do?"
March 23, 2010

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Chairman Frank, Ranking Member Bachus, and distinguished members of the Committee, I thank you for the invitation to appear at today's important hearing. I am Mark Calabria, Director of Financial Regulation Studies at the Cato Institute, a nonprofit, non-partisan public policy research institute located here in Washington, DC. Before I begin my testimony, I would like to make clear that my comments are solely my own and do not represent any official policy positions of the Cato Institute. In addition, outside of my interest as a citizen, homeowner and taxpayer, I have no direct financial interest in the subject matter before the Committee today, nor do I represent any entities that do.

Housing and Mortgage Market Principles

Any set of proposals to restructure our system of mortgage finance should begin, and be consistent, with a well defined set of principles. The principles which should guide the shape of our mortgage finance system are as follows:

- Private, at risk, capital should serve as the foundation of our mortgage finance system.
- To the extent that government provides insurance, guarantees or subsidies, those should be structured to act in a *counter-cyclical* manner. Too much of the current structure magnifies the booms and busts in our housing markets. Policy should dampen cycles, rather than exaggerate them.
- While policy should dampen housing cycles, we are unlikely to completely avoid property cycles – they remain a recurring phenomenon in our history. Accordingly, policy should explicitly recognize that housing booms and busts are likely to occur. Any policies based upon faulty assumptions, such as ever rising home prices and "it's always a good time to buy" – should be rejected.
- In planning for housing booms and busts, policies should also explicitly plan for the failure of institutions engaged in mortgage finance. While efforts should, of course, be made to reduce failures, the system should be robust to the failure of any one or two companies.
- Policies should avoid concentrating credit and interest rate risk into a small number of entities. As long as the risk is clearly understood, spreading that risk among many parties will reduce the impact of the failure of any one entity.
- The costs and benefits should be transparent and credible. Subsidies should be on-budget and easily understood. The American taxpayer has a right to know what they are obligated for; accordingly, subsidies and contingent liabilities must be properly accounted for.

- Housing policy should be tenure-neutral. The vast majority of benefits to homeownership accrue to the homeowners themselves and their immediate communities. The benefits to society at large have been grossly exaggerated and renting should be treated as a respectable alternative. Accordingly, policy should abandon any focus on a particular homeownership rate. Tenure-neutral, however, does not imply a "subsidies for everyone" approach.
- To the extent that policies encourage homeownership, that homeownership should be sustainable. Encouraging families to become owners with little or no equity ultimately harms the very families we wish to help.
- Housing policy should also focus on housing as shelter, not as a speculative investment.
- To the extent that subsidies are provided, they should be carefully targeted only to those who would not otherwise be able to have a home, or achieve homeownership. The vast majority of current subsidies go to households that would have owned without the subsidy. Subsidies should also be tied to incomes, not home prices or rents. A disproportionate share of subsidies currently goes to upper income households. There is no compelling policy rationale to provide housing subsidies of any kind to wealthy households.
- To the extent that subsidies are provided via the mortgage finance system, great care should be taken to insure that those subsidies end up with homeowners, and not simply passed along to the housing or mortgage industry.
- The current levels of leverage, both on the part of households and financial institutions, in our mortgage finance system should be reduced.
- The level of maturity mismatch in our mortgage finance system should be reduced.
- Elements of our mortgage finance system that are little more than disguised transfers of wealth should be rejected, including attempts to cross-subsidize high-risk borrowers.
- Policies whose impact is largely to run up housing prices should be rejected.
- Mortgage finance should be insulated from politics. During a boom, political pressures will generally favor further inflating the boom.

A mortgage finance recovery

Aside from addressing the future of mortgage finance is the immediate question of what to do about the current state of mortgage finance. While a variety of problems face the mortgage industry, the most important is the future direction of house prices, and the expectation of such. As long as there is a substantial chance of further declines in home prices, investors will have difficulty projecting losses on mortgage related securities. Accordingly, first Congress and the Administration should end all efforts to prop up house prices. The harm from a quick reduction in home prices, or even an over-shooting on the way down, is far less than the harm that results from holding prices above market-clearing levels. Once housing markets have reached the point where buyers and investors believe prices can fall no further, than both homebuyers and capital will return to the mortgage market in strength.

To encourage private capital to return to the mortgage market, Congress should strongly affirm the importance of respecting private contracts. Repeated calls for mortgage "cramdowns" and other threats of expropriation increase the difficulty of pricing mortgage investments and encourage investors to place their wealth elsewhere. As long as investors believe Congress may ex post re-write the terms of their investments, they will hesitate to invest at other than punitive rates. This is illustrated in the recent comments of a senior MetLife executive, who stated that "MetLife will not buy new securities until it knows what will happen to the current ones – and whether investors will have to absorb the resulting losses."[1]

As the financial crisis has receded, investors' flight to quality has also receded. The marginal investor is now again looking for higher yields. Once investors are certain that higher yields can be found in the mortgage market, and that such returns will not be subject to expropriation, then private money will return to the mortgage market in force. We are already witnessing the early stages of several private sector mortgage securitizations. Just as important is what we did not see: a shock to the mortgage market from the winding up of Federal Reserve purchases of agency MBS. For the right price, investors are willing to supply credit to the mortgage market. Current market difficulties are compounded when uncertainty as to credit risk is exasperated by political risk.

On the 30 year fixed-rate mortgage

Any discussion of reforming our mortgage finance system has to address the central role of the 30 year fixed rate mortgage. First we must begin with the very simple, yet critical, observation that someone, the homebuyer, the financial sector or the taxpayer, must bear the interest rate risk inherent in the 30 year fixed. A fixed rate mortgage does not eliminate interest rate risk, it simply transfers it. In the case of the savings and loan crisis, and the recent bailouts of Fannie and Freddie, much of that risk was involuntarily transferred to the taxpayer. It is worth remembering that most homeowners are taxpayers, so simply moving interest rate risk from homeowners to taxpayers does not make homeowners, as a group, better off. We may end up making homeowners, as taxpayers, worse off if they were not fully informed as to this transfer *ex ante*.

As the taxpayer bears some of the interest rate risk of the 30 year fixed, the price facing homebuyers is artificially low, relative to adjustable rate mortgages. Were the taxpayer no longer bearing this risk, I believe financial institutions would still offer 30 year fixed rate mortgages, however the spread of those mortgages would increase relative to adjustable rate mortgages. Historically the difference between the 30 year fixed and the 1 year ARM has been about 100 basis points. Without government support, my educated guess is that spread would increase to around 130 basis points. While this may seem like a major increase, it is 1) not large enough to adversely impact homeownership rates and 2) below some of the highs of earlier this decade – for instance in 2003, certainly a "strong" housing market, these spreads approached 240 basis points.

[1] Quote from Nancy Mueller Handal in Aline van Duyn "A Business Decision," *Financial Times* February 23, 2010 p.7.

Proposals for reforming Fannie Mae and Freddie Mac

While there are many important and critical issues to be decided in restructuring our mortgage finance system, no issue is more central than the future of Fannie Mae and Freddie Mac. Ultimate goal of any GSE reform should be to create a system, where in a time of mortgage market stress, a GSE can fail, without cost to the taxpayer or significant disruption to the financial and mortgage markets. To some extent, this will require making such markets less reliant on the GSEs and reducing the extent to which their securities permeate the financial system.

Consistent with the principles above, I recommend the following steps in reforming Fannie Mae and Freddie Mac:

- The more, the merrier. Whether purely public or purely private, having only two Fannie/Freddie like institutions guarantees that these entities will be bailed out if they become insolvent. The only way to make failure a credible option is to have several. I would suggest breaking up Fannie/Freddie into about a dozen, equal sized entities.
- Reduce ambiguity around debt status. Subject all GSE securities issues to requirements of 1933 and 1934 Securities Acts. Also remove all statutory treatment of GSE securities as "government" debt.
- Allow only issuance of MBS – no unsecured debt, no portfolio. Also eliminates risk of GSE default on money market mutual funds.
- Get GSEs out of guarantee business. MBS should represent a "true" securization, not a retaining of credit risk on balance sheet.
- Eliminate loan limits, set loan sizes based upon income, say 3 times median state income, also allows elimination of housing goals.
- Require bank regulators to treat bank holdings of GSE debt as non-governmental, corporate debt. Also limit any insured depository from holding more than a small percentage, say 5%, of its assets in GSE debt.
- Charters should be issued/removed by regulator, not Congress. Consistent with having more GSEs, allow regulator to issue new charters and conversion of other financial institutions into new GSE charter.
- Limit or bar holdings of GSE debt by foreign central banks. Fannie/Freddie bailout was as much a foreign policy decision as an economic one.
- Require all mortgages purchased by GSE to have a minimum cash downpayment of 10 percent – no piggybacks. To avoid disruptions to the mortgage market, this requirement could be phased in over a few years, starting with a cash requirement of 5 percent.
- Subject GSEs to bankruptcy code. Conservator/receiver model increases chance of bailouts, and reduces market discipline on the part of debtholders.
- New Fannie/Freddie privatization model *could* be based upon co-op model of the FHLBs. Require lenders selling loans to purchase equity, similar to FHLB advance model. This would better align incentives of lenders with the risks taken by Fannie/Freddie.

Toward a Countercyclical Mortgage Finance System

U.S. Housing Markets have tended toward a regular pattern of boom and bust. While some degree of cyclicality is likely unavoidable, federal mortgage policy has often contributed to these wide swings in housing activity. Mechanisms can be created that dampen the incentives for households and financial institutions to engage in bubble behavior. These mechanisms should, of course, be directly related to a national interest. Entities that do not pose a systemic risk to the financial system or receive backing from the taxpayer, implied or otherwise, should be free to innovate and succeed or fail.

Housing bubbles are driven foremost by the speculative behavior of households. Current federal and state policies encourage such speculation. For instance several states, such as California, require that residential mortgages be non-recourse. That is, in the case of a default, the lender can only pursue the house and not any of the borrower's other assets or income. Recent research from the Federal Reserve Bank of Richmond indicates that "recourse decreases the probability of default when there is a substantial likelihood that a borrower has negative home equity."[2] Not only does a lack of recourse increase defaults during the bust phase of the cycle, but such also likely increases the incentive of buyers to enter the market with greater speculative intent. Where there is a federal interest, all mortgages should contain recourse provisions and such provisions should be exercised.

The scholarly literature on speculative bubbles concludes that such bubbles are more likely to develop the lower are transaction costs and the lower is the required holding period of the asset in question[3]. It is for this reason that many countries, such as Canada, whose mortgage markets contain substantial pre-payment penalties, did not witness the same level of boom and bust as the U.S. housing market. We should reverse the policy trend toward eliminating pre-payment penalties and instead encourage significantly broader use of such. The ease of repeated re-financings, coupled with equity-extractions, greatly added to the severity of the boom and bust.

The most important predictor of mortgage default is equity, or lack thereof[4]. Owners that are underwater are significantly more likely to default than homeowners with equity. Requiring reasonable downpayments when the mortgage has a federal interest would significantly reduce the severity of housing cycles. Ultimately federal policy should work toward a cash downpayment of 10 percent. During booms this can be raised. For instance requiring a downpayment that is the higher of 10 percent or last year's national house price appreciation would greatly reduce housing cycles. Similarly the capital which financial institutions, including GSEs, are required to hold against residential mortgages should be linked to house price appreciation.

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[2] Ghent and Kudlyak **Recourse and Residential Mortgage Default: Theory and Evidence from U.S. States.** Federal Reserve Bank of Richmond. Working Paper WP09-10.

[3] Barlevy. "Economic theory and asset bubbles." *Economic Perspectives*. 2007. Federal Reserve Bank of Chicago.

[4] Kristopher Gerardi, Adam Hale Shapiro, and Paul S. Willen. **Decomposing the Foreclosure Crisis: House Price Depreciation versus Bad Underwriting.** Federal Reserve Bank of Atlanta Working Paper 2009-25

Systemic Risk and Mortgage Finance

While Fannie and Freddie were rescued for a variety of reasons, prominent among those is that fact that their securities, both equity and debt, permeate our financial system. For instance, more than 40% of money market mutual fund holdings were in the form of GSE securities. Were a receiver to impose substantial losses on short-term unsecured GSE debt, hundreds, if not thousands, of money market mutual funds would have "broken the buck." Same with insured commercial depositories. According to the FDIC, before the bursting of the housing bubble, holdings of government-sponsored enterprise (GSE) securities, bonds and mortgage-backed securities as well as preferred stock, constituted more than 150% of Tier 1 capital for insured depositories. If we thought bank losses from the reduced value of Fannie and Freddie preferred shares was a problem, these losses would have been rounding errors compared to bank losses from Fannie and Freddie debt. Sadly Wall Street was also infected. For instance, the Federal Reserve has reported that more than 50% of Maiden Lane One assets, the toxic assets that the Federal Reserve guaranteed in order to persuade JPMorgan to buy Bear Stearns, were GSE securities.

Our country has witnessed housing booms and busts before, although not one of this magnitude. The fallout from such a large bubble bursting was guaranteed to be painful and prolonged. However, the resulting financial crisis did not have to result. The financial crisis resulted from the fact that so much of the soundness of our financial system is build upon the sand of house prices.

Innovation, Standardization and the Unknowable Future

Given the clear role that many facets of our current mortgage finance system played in creating the housing boom and bust, it is tempting to proscribe a set of standards for the mortgage market and require all participants to meet those standards. Such would be a tragic mistake. The better path would be to allow essentially two systems: one for institutions that place the taxpayer and the financial system at risk, and one for non-depositories and non-banks that do not place the taxpayer and system at risk. Entities should be able to choose under which system they operate, ultimately allowing the free choice of individuals to determine the better system. Such a system would also allow innovations that improve consumer welfare without putting the financial system at risk.[5] We have already seen the result of concentrating mortgage risk into a small handful of entities; we must avoid repeating that mistake. In addition to avoiding the concentration of risk into a few entities, we should also avoid the concentration into a few business models. According, we should closely examine the possibility of utilizing various forms of mortgage finance, including, but not limited to covered bonds, portfolio lending, and mortgage backed securities.

[5] See generally, "The Impact of Deregulation and Financial Innovation on Consumers: The Case of the Mortgage Market." with Paul Willen, Kristopher S. Gerardi and Harvey Rosen. *Journal of Finance*, forthcoming.