"Restructuring Fannie Mae and Freddie Mac"

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I: Introduction

Chairman Kanjorski, Ranking Member Garrett, and other distinguished members of the Committee:

Thank you for the invitation to testify at today's hearing on "The Present Condition and Future Status of Fannie Mae and Freddie Mac." It is my honor to be here today to discuss the role of secondary mortgage market institutions in contributing to the crisis and what form these institutions should take going forward. My testimony is based on research in conjunction with co-authors Richard Green, Adam Levitin, Patricia McCoy, and Andrey Pavlov. (The articles are cited at the end of the written testimony.)

The government sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, have provided a secondary market for mortgages originated by banks and mortgage brokers. In so doing the GSEs may have contributed to homeownership gains, but what is most important to the nation going forward is developing and maintaining a housing finance framework that supports homeownership that is sustainable and that contributes to overall financial stability.

Broadly speaking, there are three options for the future of the GSEs: (1) privatization; (2) nationalization, and (3) a return to their original federal charter as hybrid public-private entities. I will outline here the pros and cons of these three approaches and the factors that should be considered as the subcommittee, and indeed the nation, weigh the options.

Privatization of the GSEs in theory could have the benefit of de-socializing the risk involved with secondary market housing finance. Critics argue that their special access to cheap credit and high leverage exposed the taxpayer to large liabilities. However, as we have seen in recent experience, privatization does not exempt the taxpayer from such liabilities.

A second possibility is to nationalize the GSEs and have a solely public secondary market, essentially FHA/Ginnie Mae for everyone. Taxpayer exposure to large liabilities is still a risk in a solely public sector approach. There is automatic socialization of risk and no market check on underwriting because of the US government guarantee.

The third possibility is a hybrid public-private secondary market. An example of this is the current Fannie Mae/Freddie Mac system. Despite potential pitfalls, hybrid public-private GSE financing worked fairly well until private-label securitization arose. The GSEs found themselves losing market share, and the GSEs' shareholders pressured the GSEs to lower underwriting standards to compete, while federal regulators did nothing to stop it.

In fact, it is useful to think of privatization and nationalization as one choice not two because nationalization effectively means that the existing FHA function is augmented with a larger sphere for lending and the private sector would of course be likely to continue its securitization of residential mortgages much as it did prior to the crisis, with a major re-expansion of private label securitization, once markets are stabilized. Such an expansion would likely take over much of the market in the absence of government-regulated and -chartered entities.

Within the hybrid public-private approach, there are various options, such as cooperative versus shareholder ownership and choices on regulation such as a public utility approach versus a larger role for the federal government in governance. These choices are not inconsequential in system design. But today I will focus on the larger pros and cons of this middle ground versus the alternative of a federal government entity and GSE privatization. While this issue is complex and multifaceted, the overriding question is, which of these alternatives best serves the interests of the public?

This question needs to be addressed in the light of the fundamentals of the mortgage market and mortgage instrument itself and especially needs to take into consideration lessons learned from recent and past financial crises. The principles that need to be relied upon as choices of the form of restructuring are considered include the fundamental role of the mortgage instrument in consumer welfare outcomes and the effects of alternative structures on overall stability of the financial system. Changes in the form of the GSEs will impact whether and how mortgages are securitized going forward and through this the welfare of the borrower and stability of the overall financial system.

The public has an interest in systemic stability in the financial system. Individual households are the least well equipped to weather instability in the financial system. In addition to financial stability, a key public interest in mortgage finance is consumer protection. Consumers do not want to have to worry about whether fine print or predatory lending will result in them losing their home and their investment. Consumers want the process of financing homeownership to be fair and transparent.

Moreover, from a household portfolio perspective, it is economically beneficial for the duration of borrowing for and investing in the home to be matched. The long term fixed-rate mortgage supports the goal of most families to at least have the option of continuing to live in their homes and neighborhoods. Exposing borrowers to unpredictable short term cost fluctuations which is unavoidable with adjustable rate mortgages can undermine this objective. This duration matching is what a long term fixed-rate mortgage provides to homeowners. At the same time, the fact that mortgages can be prepaid rather easily allows households to duration match human capital with mortgages.

In all these regards, the public interest could be served by a secondary market of governmentally-regulated entities with private sector capital at risk that securitized only a standardized mortgage product. Such a hybrid public-private secondary market system could promote sustainable homeownership *and* systemic stability.

The original purpose of the federal charters for the GSEs was to provide a link to long-term capital markets to support fixed-rate mortgages, which evidence suggests, banks are otherwise unlikely to offer. This purpose supports systemic stability both through the prevalence of a standard fixed-rate mortgage and through standardization and limitation of default risk. While regulation of this risk is supervised by an entity of the federal government, losses through excessive risk-taking are also borne by private shareholders.

To understand the importance of a secondary mortgage market and the standardization of mortgage products for fair, affordable, and sustainable homeownership that does not engender systemic risk, it is only necessary to note that historically in the US, housing finance was provided through banking systems, funded by demand deposits. In most countries today deposit-funded banks remain the predominant, if not sole, source of funding for mortgage borrowing. In countries with bank provided mortgages, adjustable-rate mortgages predominate and the long term fixed-rate mortgage is largely absent.

As colleagues and I have shown real estate, including residential real estate, has been linked to financial crises not just once but many times. Real estate crashes and banking crises tend to occur together. In our own recent history, the savings and loan crisis of the 1980s both contributed to the recession of 1990-1991 and destabilized the financial system requiring a federal bailout. Securitization and the growth of the secondary market was the outcome of this crisis with the recognition that the stability of the banking sector depended upon ending banks' lending long, financed by short-run demand deposit liabilities.

The US was an exception in continuing to provide fixed-rate mortgages in the aftermath of the Savings and Loan and related crises. In response to the Great Depression, the Federal National Mortgage Association ("Fannie Mae" or FNMA) had been set up as a government entity to buy mortgages at par from banks. After the S&L debacle, Fannie Mae was used to purchase bundled underwater mortgages from troubled thrift institutions. Going forward, banks continued to use Fannie Mae and later Freddie Mac to purchase fixed-rate mortgages. The transfer of interest rate risk on fixed-rate mortgages from banks to the GSEs and thus to the capital markets allowed United States banks to continue to offer borrowers access to fixed-rate loans.

Elsewhere, in the absence of a secondary market institution, banks provided borrowers adjustable rate mortgages. The exceptions to this besides the United States is Denmark and, to a lesser extent, Germany. Both of these countries also historically had in place extensive secondary market institutions, which while they differ from those of the US, do in fact link long-term funders to long-term borrowers.

Fannie Mae and Freddie Mac grew with banks' continued securitization of long-term mortgages. The growth occurred both in the GSEs' guarantee business, in which they guaranteed mortgages bundled into pass-thru securities and sold to investors and in their portfolio purchases of mortgage securities. The growth of the secondary market coincided with a period of financial and economic calm known as the Great Moderation.

The controversy over their continued growth was to a great extent focused on the growth of their portfolios. Ultimately it was viewed that these institutions were implicitly guaranteed by the federal government. Thus, with the growth of the portfolio, taxpayers were liable for interest risk taken on by these institutions. Interest rate risk it was viewed was an unnecessary risk for the GSEs to take on.

Importantly, however, their federal charter did require them to set standards that they could verify for mortgages to minimize default risk. This was necessary for their purpose because the GSEs guarantee mortgages originated by other institutions from across the United States. The GSEs adopted uniform mortgage codes, which were implemented through issuing guidelines, monitoring, and standardized contracts and eventually automated underwriting.

The current crisis came about not with the growth of the GSEs, but rather with the growth of private-label mortgage securitization. In an era of deregulation, private-label securitization drove the demand for new types of risky mortgages. The demand for securitized mortgages fed the demand for recklessly underwritten loans. As private-label MBS grew in market share, so did non-standard mortgages from 15% of market origination in 2002 to almost half of market origination in 2006. Lending standards were not monitored for private-label securitization and declined over time. Surprisingly, so did risk premiums, as Wall Street encouraged such lending, despite growing risk. Home prices were buoyed by the willingness of institutional investors across the world to buy these subprime loans in the form of complex securities created by investment banks.

As lending standards deteriorated and the cost of these mortgages declined at least for the short run, the demand for homes and the price buyers were willing and could pay was driven up. There was no and is no regulation in place to stop the deterioration of lending standards over time driven by the competition for market share for loans. This lending was not sustainable and resulted in a credit bubble that burst, bringing down not only poorly underwritten nontraditional loans, but carefully underwritten traditional loans as well.

The private-label securities backing these label loans were not liquid nor did they bear risk premia based on their issuers and the underlying loans' originators' balance sheets. Because these securities were not backed by standardized assets, they generally did not trade. Even if short sellers knew of the heightened risk and mispricing of securities, it was difficult to trade on this knowledge. Private-label securities were marked to model, not to market. Evidence of misallocated investment and growing risk was masked by the fact that the looser standards buoyed housing prices in the short term. The price bubble fueled by poor underwriting also increased the risk exposure of the entire mortgage system given the inevitable collapse of inflated prices. Home prices plummeted, so sharply that by the spring of 2009, every fifth borrower owed more than his or her home was worth and defaults rose to postwar records: almost one out of every twenty-five borrowers is in foreclosure. This is the systemic risk that securitization without regulation engendered.

While it is clear that systemic risk derives from the pro-cyclical erosion of lending standards, there is not yet a consensus on how to avoid this going forward. While no system is perfect, securitized fixed-rate long term mortgages are critical for a stable mortgage system and that robust, standardized securitization is unlikely to be accomplished by an FHA like government entity alone. Central to the success and stability of a housing finance system is regulation of mortgage securitization, and, as I discuss in an article with Georgetown University Law Center Professor Adam Levitin, a key piece of this is the regulatory standardization of securitized mortgages. Standardization promotes liquidity, ensures suitability, and enhances system stability.

Standardized mortgage products enhance secondary market liquidity because there is substantial interchangeability to securitized mortgage pools. This means investors have to spend less effort investigating mortgage investments. Liquidity makes investment in the secondary mortgage market more attractive to investors, and this benefits consumers in the form of cheaper and more plentiful mortgage credit.

A key part of standardization is to ensure that mortgages are negotiable, meaning that there is not assignee liability; negotiability protects good faith secondary market purchasers from the mortgagor's claims and defenses against the originating lender. This means that secondary market purchasers do not need to worry about the particular circumstances of any mortgages' origination, which means they can purchase with more confidence, which enhances liquidity.

Standardized mortgage products also benefit consumers in terms of suitability. For the vast majority of consumers, a fixed-rate, fully amortizing mortgage is a suitable product. The purpose of home purchasing is long-term residency, and fixed-rate mortgages are well-designed for long-maturity loans. The long-term fixed-rate mortgage provides a stabilizing factor in household finance. Mortgages are typically consumers' largest single monthly payment obligation. A fixed, steady housing obligation allows consumers to plan their finances around it, and shields consumers from interest rate shocks that they are poorly positioned to predict or hedge against. A standardized mortgage product also protects consumers from negative innovation; there's no place for tricks and traps in a standardized product, and consumers are able to benefit from shared social knowledge about the product. Finally, standardized products make it very easy for consumers to get the best price on a mortgage because it enhances price disclosure; when consumers compare mortgages apples-to-apples, they can easily find the best deal.

Standardization also promotes system stability. Real estate has been the source of many economic crises because it is impossible to short real estate directly. While real estate can be shorted synthetically through derivatives, such as credit default swaps, if standardized and liquid, real estate cannot be shorted directly due to inherent heterogeneity. By enhancing liquidity, standardization makes it possible to short real estate, which provides an important market discipline counterbalance to the optimism that has fueled past bubbles.

To be sure, mandatory standardization can stifle innovation. Innovation, however, is not always positive for social welfare. Indeed, many of the innovations in the mortgage market in recent years have had affirmatively negative impacts. Many of the innovations in the mortgage market have begun as niche products (pay-option ARMs, stated income loans, interest only loans) for sophisticated, targeted consumer groups, but were expanded to mass markets for which they were entirely unsuited. The risks with these niche products were not well understood by either consumers or investors.

In any event, standardization need only apply to securitized mortgages. Financial institutions could still originate non-standard mortgage products and hold them on their books or resell them to each other. This means that financial institutions could continue to serve as a laboratory for product innovation. But they would be required to retain the risk on those products. This is the proper niche for niche products.

The hybrid public-private approach has advantages for financial stability and consumer protection because it encourages standardization of mortgages. A private-bank, deposit-based system cannot deliver long-term, fixed-rate mortgages without severe cycles and crises such as the savings and loan crisis of the late 1980s. The charter approach can resolve this challenge by increasing the accessibility of long-term, fixed-rate mortgages, which are clearly in the public's interest. Thus as we consider the future of securitization we need to keep in mind that for decades regulated securitization led to the ubiquity of the standard long term fixed-rate American mortgage which provided both stability to borrowers and to the financial system.

The federal charter required the GSEs to standardize, and therefore commoditize, mortgages, and so they allowed investors and borrowers to understand mortgages and evaluate risks based on knowledge. If we are to return to a federally chartered system of GSEs, I believe that there should be safeguards in place to discourage excessive risk taking and to specifically discourage such short-term profit seeking. Moreover attention should be paid to the role of the public members of the board of directors of these entities. From a corporate governance perspective, their responsibilities should explicitly include the oversight of systemic risk. Since regulation in itself is not fool proof in maintaining lending standards it is useful to have capital at risk, nonetheless.

The GSEs should not be removed from conservatorship until the economy is on a stable recovery path. They are currently helping to stabilize economy through their support of the housing market. This effort is especially critical in light of recent discussion over government purchase of toxic assets that may be difficult to price and liquidate. In the future, the benefits for long run stability and consumer protection point to the need for strongly regulated and private-market-disciplined entities to support the U.S. housing finance system.

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