

TESTIMONY OF DR. CHRISTOPHER J. MAYER
BEFORE THE SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

HEARING: "STATE OF THE HOUSING MARKET: REMOVING BARRIERS TO ECONOMIC RECOVERY"

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Good afternoon Chairman Johnson, Ranking Member Shelby, and Members of the Committee. Thank you for inviting me to speak today. My name is Christopher J. Mayer. I am the Paul Milstein Professor of Real Estate at Columbia Business School. I have spent the last 18 years studying housing markets and credit while working at the Federal Reserve Bank of Boston and serving on the faculties of Columbia Business School, the University of Michigan Business School, and the Wharton School of the University of Pennsylvania. I also serve as Visiting Scholar at the Federal Reserve Bank of New York.

The Federal Reserve recently issued a White Paper documenting many of the frictions in the housing finance system and suggesting how such frictions have had a negative impact on the housing market and the economic recovery. The Federal Reserve points out that "Obstacles limiting access to mortgage credit even among creditworthy borrowers contribute to weakness in housing demand, and barriers to refinancing blunt the transmission of monetary policy to the household sector."

Despite record low interest rates, mortgage activity has fallen precipitously. According to the Mortgage Bankers Association, the dollar volume of mortgages originated to purchase homes in 2010 (the last full year of data) has fallen to the same level as in 1992 (see Figure 1, at the end of this testimony). Although one might have expected large numbers of refinancings because of low rates, refinancing activity in 2010 was, in fact, at the second lowest annual level since 2001 (Figure 2). So far, through the 3rd quarter of

2011, mortgage lending is down almost 19 percent from the same period in 2010. By comparison, according to Equifax Origination Credit Trends, new consumer lending is up 11.1 percent on a year-to-date basis in November 2011 from the previous year, showing increases in nearly every category including auto lending, credit cards, consumer finance, and student loans.

Other housing data released since the White Paper was published continue to highlight the negative picture of the housing market that the Federal Reserve discusses relative to the rest of the economy. S&P/Case-Shiller indexes for 20 cities in November fell 1.3 percent from October and 3.7 percent for the full year, both larger decreases than anticipated and stoking fears that home prices might start falling again if foreclosures pick up, as they inevitably must. Lender Processing Services reports that 8.15 percent of mortgages are delinquent and 4.12 percent of mortgages are in some stage of foreclosure; both numbers that are nearly identical to June 2011. The share of mortgages that were current 6 months earlier but seriously delinquent now is higher than it was in June 2011. In other words, even as the labor market has started to improve, the housing market remains mired in difficulties.

Stepping back, it is important to understand the role of government interventions in the housing market and the unintended consequences. After housing prices went into a free fall in 2007, private mortgage credit collapsed shortly afterwards. Newly issued private first mortgage securitizations, which once were nearly a trillion dollars per year, fell to almost zero. Government sponsored entities Fannie Mae and Freddie Mac (the GSEs) along with the Federal Housing Administration (FHA) quickly came to dominate the market. Yet soon the bond market became leery of lending to the GSEs, which did not have an explicit guarantee on their debt. With their solvency in doubt, the federal government backstopped the GSEs by putting them in conservatorship in September 2008. The Federal Housing Finance Agency (FHFA), an independent government agency and previously the GSE's regulator, became the conservator, taking over management of the GSEs. As well, the government provided an explicit guarantee on their debt. The government began further backing the GSEs when the Federal Reserve announced at the end of 2008 that it was beginning the purchase of what eventually became nearly \$1.25 trillion of GSE securities.

Fannie Mae and Freddie Mac Under Conservatorship

In 2008, Congress passed the Housing and Economic Recovery Act (HERA). Under HERA, which tasked the Director of the FHFA to ensure the GSEs meet a number of conditions, including:¹

- i) “each regulated entity operates in a safe and sound manner...”
- ii) “the operations and activities of each regulated entity foster liquid, efficient, competitive, and resilient national housing finance markets...”
- iii) “the activities of each regulated entity and the manner in which such regulated entity is operated are consistent with the public interest.”

Soon after taking over conservatorship of the GSEs, Director James Lockhart restated the agency’s mission:²

Provide effective supervision, regulation and housing mission oversight of Fannie Mae, Freddie Mac and the Federal Home Loan Banks to promote their safety and soundness, support housing finance and affordable housing, and support a stable and liquid mortgage market.

As well, GSEs were required to start to reduce the size of their retained portfolio of mortgages and mortgage-backed securities (MBS). While many critics and observers also expected or hoped that FHFA conservatorship would set the stage for the eventual wind down and replacement of the GSEs, no such mandate was given to the FHFA. In fact, Director Lockhart noted the strategic goal under conservatorship, “FHFA preserves and conserves the assets and property of the Enterprises, ensures focus on their housing mission, and facilitates their financial stability and emergence from conservatorship.” Nowhere was there a goal to eliminate the GSEs.

Unfortunately for taxpayers, homeowners, and the economy, in the more than three years since FHFA has taken over conservatorship of the GSEs, the enterprises have

¹ See H.R. 3221-11. I have abbreviated the rules to focus on the relevant parts of the legislation for this testimony. This is not a complete list of all legislative requirements.

² FHFA Strategic plan, 2009-2014.

continued to act as profit maximizing private firms, taking advantage of their market power in the mortgage market to earn profits rather than working to make the market more efficient. In doing so, the GSEs have taken a very narrow, and arguably, ineffective and harmful approach to managing their activities. These actions have resulted in enterprises that are arguably no easier to wind down today than they were three years ago. This is despite the fact that almost all commentators and policy makers have suggested that the GSEs as currently constructed do not represent an attractive way to finance US housing in the future.

Maybe the single biggest problem with the ongoing operation of the GSEs has been to failure to adequately address critical conflicts of interest in their operations. The evidence suggests that the conflict of interest between the businesses of providing mortgage guarantees and managing a large retained portfolio of mortgages and MBS have led to the obstacles to normal credit conditions. This conflict of interest was raised in recent reporting by National Public Radio and ProPublica.³ In its White Paper, the Federal Reserve noted that “...easing some of these obstacles could contribute to the gradual recovery in housing markets...” Even without considering the overall economy, GSEs should be concerned with the health of the housing market, since they now hold the risk for more than one-half of all outstanding mortgages. Thus, absent a conflict of interest, it would appear to directly benefit the GSEs to remove some of the obstacles the Federal Reserve discusses.

There are plenty of examples of how this conflict of interest might have led the GSEs to take actions that padded their portfolio profits, even while harming the mortgage market and the larger economy. Many credit market decisions by the GSEs seem to be driven by a desire to block refinancing⁴. Fannie Mae raised up-front fees on all new loans just weeks

³ See the recent story from National Public Radio and ProPublica, <http://www.propublica.org/article/freddy-mac-mortgage-eisinger-arnold>.

⁴ In response to recent allegations of conflicts of interest, the FHFA has pointed out that refinancing represents a large portion of the GSEs overall business. As I discuss below, this fact is not inconsistent with the allegations of a conflict of interest. Many of the restrictions on refinancing did not impact all borrowers, but instead reduced refinancing by borrowers with high mortgage rates that may also be held in GSE portfolios.

after the Federal Reserve announced its MBS purchase program, with Freddie Mac following suit two months later. These new fees applied even in cases where borrowers' mortgages were already guaranteed and their refinancing not impose any additional risk. The GSEs have taken steps to reduce competition between servicers, despite borrowers' many complaints about poor service by their existing servicers. Shrinking lending, increasing legal liability, and other GSE policies appear to have contributed to a lack of competition to originate mortgages, leading to retail spreads on mortgages that remain near at all-time highs. The GSEs have failed to address critical problems in the mortgage insurance industry, leaving many consumers locked into high interest rate mortgages and making mortgage modification more challenging and less effective. Since refinancing and mortgage modification as well as lower retail spreads on mortgages reduce the cost of mortgage guarantees by reducing defaults, the only seemingly plausible reason for such policies is to protect high interest payments on mortgages and MBS held in the GSE's portfolio.

The reports by National Public Radio and ProPublica highlighted how these conflicts of interest may also have influenced portfolio decisions at Freddie Mac. Instead of selling off the MBS that it inherited when it entered conservatorship, Freddie Mac appears to have created and held complex, highly leveraged mortgage derivatives that are risky and nearly impossible to sell. In addition, Freddie Mac created new and complex long-term financing for its MBS positions (called Mortgage-Linked Amortization Notes, or MLANs) rather than choosing to sell these securities into the open market and reduce the size of its portfolio business.⁵ These transactions highlighted the appearance of a conflict of interest since the transactions were structured so that the enterprise lost valuable interest payments if borrowers with very high interest rates were able to refinance their mortgages, a policy that is substantially under the control of Freddie Mac. Whether intended or not, these transactions also make it harder to unwind Freddie Mac and its portfolio in the future.

While seemingly consistent with the strategic goal listed above of conserving and preserving assets to emerge as an ongoing entity, the policies described above appear to

⁵ <http://www.businessweek.com/news/2012-01-17/freddie-mac-sees-selling-40-billion-of-debt-tracking-mortgages.html>

violate a number of the GSE's other mandates, which are to "foster liquid, efficient, competitive, and resilient national housing finance markets" and to operate in a manner "consistent with the public interest." From the first quarter of 2008 to the first quarter of 2011, the market share of the top five mortgage originators has grown from 56 percent to 65 percent. As well, according to Bloomberg (Figure 3) the spread between retail and wholesale mortgage rates has widened by at least 0.75 percent (75 basis points) between its average from 2000 to 2007 and its level at the end of 2011. These facts suggest that conservatorship has resulted in less competitive and less efficient mortgage markets.

The Dueling Business Interests of the GSEs: A Conflict of Interest?

To better understand these issues, it is important to look at the historical context in which the enterprises arrived into conservatorship. When the FHFA took over the management of Fannie Mae and Freddie Mac (GSEs), the enterprises had two principal businesses: mortgage guarantees and portfolio management. The mortgage guarantee business involves collecting premiums and insuring bondholders against credit losses. When a borrower defaults on a mortgage, the GSEs must buy the mortgage out of a pool at par, so bondholders are made whole. The portfolio business involves owning and managing a large balance sheet made up of mortgage-backed securities (MBS) and mortgages. Both businesses were considered to be in serious financial trouble when the GSEs entered conservatorship.

The guarantee and portfolio businesses have always involved an inherent conflict of interest—the GSEs know more about the mortgages in the MBS than other parties. One study by researchers at the University of California at Berkeley and Barclays argued that the mortgage-backed securities market was a market for lemons.⁶ The article showed that securities that Freddie Mac sold to the market were of lower quality than those it didn't sell. Traders have always recognized that the GSEs were more informed than they were and market prices reflected this friction. Financial economists would note that the existence of some traders using non-public information inherently leads to less liquid and efficient

⁶ Downing, Chris, Dwight Jaffee, and Nancy Wallace. 2009. "Is the Market for Mortgage-Backed Securities a Market for Lemons?" *Review of Financial Studies*, 22(7):2457-2494.

markets, as other traders must account for adverse selection when bidding on securities.

Most public policy concern about the growth of the GSEs portfolio was not about conflicts of interest, however, but risk. During the 2000s, the retained bond portfolio grew rapidly, taking advantage of their implicit guarantee by taking on additional risk on behalf of taxpayers. The GSEs even began to purchase securities with risky subprime mortgages that were specially designed for them to acquire.

In 2008, the FHFA inherited the management of firms with \$1.1 trillion of MBS, hundreds of billions in mostly failed mortgages, and a bankrupt guarantee business. As well, with the demise of private securitization and the fragile state of the financial services sector, the GSEs and the FHA were guaranteeing more than 90 percent of new mortgages, a condition that continues today. Without competition in new mortgage origination, the conflict of interest between mortgage guarantees and portfolio management once again rose to the forefront. After all, actions that might lead to even a small percentage change in the value of the portfolio would have a material impact on profits of these formerly semi-private companies.

Soon after conservatorship, in December 2008, Fannie Mae announced LLPAs (loan level pricing adjustments), up front fees that would be paid by all borrowers on newly originated mortgages. These fees, when combined with adverse market delivery charges, could equal more than three percent of the mortgage amount, to be paid up front. Freddie Mac soon followed with its own fees, although it never posted its fees online the way Fannie Mae did.

While such fees have sometimes been defended as an attempt to add risk based pricing to mortgage originations, they were also applied on an equal basis to borrowers who were refinancing mortgages that the GSEs already guaranteed. The Federal Reserve White Paper referred to such fees as “hard to justify” when applied to refinancing their own mortgages. As well, imposing new, large up-front fees in the middle of a serious recession and stock market decline when down payments were scarce had the practical effect of reducing demand for mortgages among affected borrowers. A seemingly preferable alternative would have been to increase the annual guarantee fee (so-called “g-fee”) on mortgages for new purchases, which would likely have had a smaller negative impact on demand. A fee structure that decreased demand for new mortgages also would have cut the

demand to purchase homes, helping to contribute to a further decline in home prices. Falling home prices materially increased losses in the GSE's mortgage guarantee business. However, from the perspective of the portfolio, an equivalent increase in the g-fee rather than a higher up-front borrowing cost (LLPAs) might have allowed a much larger wave of refinancings, possibly leading to portfolio losses. These large up-front fees were not a market outcome nor were they mandated in any way by conservatorship, but were a barrier imposed by the GSEs themselves, seemingly designed to protect their own portfolios from prepayments, the very outcome that the Federal Reserve's MBS purchase program sought to create.

The high up-front fees when applied to mortgages they already guaranteed was just one of many steps the FHFA and the GSEs have taken since conservatorship that have had the effect of preventing refinancing of many mortgages. As early as September 2008, Glenn Hubbard and I have argued for the government to facilitate widespread refinancing to reduce defaults, help stabilize the housing market, and stimulate the economy.⁷ In our own analysis, Alan Boyce, Glenn Hubbard, James Witkin and I have shown how a slightly higher g-fee on refinancings would create a structure whereby the GSEs could more than recoup any portfolio losses. David Greenlaw (Morgan Stanley), Mark Zandi (Moody's Analytics), Bill Gross (Pimco), and many economists made similar arguments in the intervening years, but with little success.

In March 2009, the President announced the HARP (Home Affordable Refinance Program). The program was an attempt to streamline refinancings, but eventually resulted in fewer than one million refinancings over a period of nearly three years. While HARP officially applied to borrowers with a loan-to-value ratio (LTV) of up to 125 percent, technical barriers prevented take-up by all but a few borrowers with LTVs above 105 percent. And up-front GSE fees (LLPAs) still applied to HARP mortgages. As well, under HARP, only the borrower's existing servicer could effectively pursue a new refinancing. Even today under the new so-called HARP 2.0, existing servicers have a large advantage over new servicers in pursuing a HARP refinancing for a given borrower.

⁷ See a history of our research on widespread refinancing along with our current proposals on our website: <http://www4.gsb.columbia.edu/realestate/research/housingcrisis>

HARP also excluded borrowers with LTVs of less than 80 percent. While some such borrowers might have had an easier time pursuing a refinancing, many of these borrowers were still subject to up-front fees and other barriers. LLPAs were charged for borrowers with LTVs in excess of 60% and FICO scores below 760. Reps and warranties liabilities likely prevented many such borrowers from getting attractive quotes from other lenders. Also, many borrowers with seemingly low LTVs had second liens, so that these borrowers would likely have an elevated risk of default and thus could benefit from lower mortgage payments.

Finally, all of the exclusions from HARP had an additional negative effect on taxpayers and the overall economy. For example, Joseph Tracy and Joshua Wright of the Federal Reserve Bank of New York point out that refinancings are not simply a zero sum game and might instead “...stabilize the housing market and support economic growth.”⁸

From the perspective of the mortgage guarantee business, it is difficult to understand why the GSEs would limit refinancing on mortgages that they already guaranteed. A widespread refinancing program that lowered payments for risky mortgages would almost surely reduce defaults.⁹ In fact, from the perspective of the mortgage guarantee business, one might have expected the GSEs to go out of their way to refinance the riskiest borrowers, who would otherwise be at greatest risk of default. Yet the barriers imposed by the GSEs had exactly the opposite effect, severely limiting refinancing by the riskiest borrowers. The fees on refinancing were highest on mortgages where the borrower had a low FICO score or high LTV. Mortgages with high loan-to-value ratios were locked out of refinancing altogether.

Looking back, the costs of these actions have become clear. According to my own calculations using data from Lender Processing Services, about one-sixth of all GSE guaranteed mortgages with a mortgage rate above 6 percent in 2009 defaulted, compared to defaults by about one in fifty mortgages with rates below 5 percent. Almost surely a

⁸ <http://libertystreeteconomics.newyorkfed.org/2012/01/why-mortgage-refinancing-is-not-a-zero-sum-game.html>

⁹ Early research on the HAMP program showed the mortgage modifications that lowered mortgage payments had a strong impact on reducing defaults. See Federal Reserve Bank of New York Staff Report #417, originally published in December 2009, for example.

program to refinance high mortgage rate borrowers would have lowered this default rate for this population, saving the GSEs from some large losses from their mortgage guarantee business and reducing the number of foreclosures and short sales that have contributed to falling house prices and thus even larger future costs from mortgage guarantees. In fact, the Congressional Budget Office's recent paper on found that about for every 1,000 refinancings that took place, 38 defaults would be prevented.¹⁰ According to the CBO, such a program would have saved the GSEs billions of dollars in lower guarantee costs. A program that facilitated millions of refinancings might have prevented hundreds of thousands of defaults.

It appears only possible to understand this behavior by looking at the GSEs' portfolio management business. In fact, the CBO pointed to possible portfolio losses when considering the costs and benefits of a widespread refinancing program. While the GSEs have never disclosed much detail about their portfolio holdings, many of their purchases of mortgage-backed securities seem to have taken place in the mid-2000s. The mortgages in these mid-2000s pools have mortgage rates that are 5.5 percent or above. These loans have much lower mortgage balances, which indicate lower income households, and may be more likely to be under financial stress. In other words, many of the mortgages inside the securities held in GSE portfolios may also have been those at the greatest risk of default. Refinancing mortgages for responsible borrowers who were current on their mortgages, but also at great risk of default, might well have imposed losses on the GSE portfolios while saving significantly more for their credit guarantee businesses.

Let me put the hypothesis directly. The possibility of protecting their portfolios explains why the GSEs have been so resistant to refinancing certain mortgages. If not for the conflict of interest between the portfolio and mortgage guarantee businesses, why else would the GSEs have imposed so many barriers to refinancing?

Did Freddie Mac "Bet Against Refinancing?"

Last week, National Public Radio and ProPublica reported that Freddie Mac created risky securities called Inverse IO Floaters that had the appearance of betting against

¹⁰ http://www.cbo.gov/ftpdocs/124xx/doc12405/09-07-2011-Large-Scale_Refinancing_Program.pdf

household refinancing. These securities involve creating a concentrated risk position that pays off only as long as the underlying mortgages continue making payments. If the mortgages refinance, the payments stop and the securities lose significant value.

The FHFA responded with a statement arguing against the premise of the story. It claimed that “Freddie Mac’s retained portfolio investment in inverse floaters did not have any impact on the recent changes to the Home Affordable Refinance Program (HARP). In evaluating changes to HARP, FHFA specifically directed both Enterprises not to consider changes in their own investment income as part of the HARP evaluation process.” As well, it argued “Of Freddie Mac’s \$650 billion retained portfolio, only \$5 billion is held as inverse floaters.” As well, FHFA points out that about 80 percent of its recent business is refinancing mortgages.

It is important to understand what the statement says and what it does not. This statement does not imply that Freddie Mac’s credit decisions prior to HARP 2.0 in November 2011 were unaffected by its portfolio. In other words, the statement does not deny that the conflict of interest between lending and portfolio management might have impacted Freddie Mac’s past practices. In fact, as argued above, the retained portfolio appears to be the only plausible reason to impose many of the lending restrictions that the GSEs have imposed over time. What remains puzzling, as well, is why Freddie Mac and not Fannie Mae imposed new and harsher restrictions on refinancing some mortgages under HARP 2.0. If not for the portfolio, why would Freddie Mac impose new restrictions on HARP 2.0 refinancings?

A recent posting by Alan Boyce on the website www.zerohedge.com helps explain why FHFA’s statement might be true but that the conflict of interest might still have materially impacted lending.¹¹ For example, Mr. Boyce shows how the Freddie Mac might have simultaneously been refinancing some borrowers while also protecting its portfolio. The highest rates of refinancing have been for borrowers with relatively low mortgage rates, large loan balances, high FICO scores and low LTVs originated between 2009 and

¹¹ <http://www.zerohedge.com/contributed/qa-alan-boyce-freddie-mac-and-inverse-floaters>

2011. These loans were made after conservatorship and at a time that Freddie Mac was reducing its MBS holdings. Refinancing such mortgages may be good business, but it does not change the GSE risk profile much, because these mortgages are already unlikely to default. But, of course, Freddie Mac may not own many securities that contain recently originated mortgages.

NPR/ProPublica identified \$3.4 billion of inverse IOs, which were backed by the interest payments on about \$19.5 billion of mortgages. FHFA said that these risky derivatives were in fact larger, amount to \$5 billion in size, which could have been backed by \$26 to \$30 billion of loans. The FHFA notes that inverse IO floaters represent only a small portion of Freddie Mac's portfolio, implicitly suggesting that such a small stake cannot possibly drive their lending restrictions. These trades took place in a six month time period and had the effect of reducing the total balance sheet of Freddie Mac by almost exactly the amount required by Congress, not an insignificant sum. In addition, FHFA does not describe the characteristics of the rest of Freddie Mac's \$224 billion holdings in its own MBS. Is the remainder of Freddie Mac's portfolio also composed of high interest rate mortgages that Freddie Mac has spent more than three years imposing restrictions and prohibitions on refinancing? The entire Agency MBS market is trading at a premium, which means that every bond is well above par. It cannot be the case that taking an illiquid and highly levered position in inverse IOs can provide any hedge value for the rest of their portfolio. In fact, such a position would represent additional risk, in the same direction as its other holdings. Portfolio holdings may also explain why Fannie Mae has pursued refinancing restrictions that are nearly as strict as Freddie Mac. Fannie Mae owns nearly as much MBS as Freddie Mac.

Mortgage Modifications under Conservatorship

Rather than pursue a widespread refinancing program to help reduce credit losses, the GSEs have attempted to manage the defaults of risky mortgages once they occur. The problem has been that the GSEs have also been slow and less effective at adopting loss mitigation practices that the private sector has identified.

Private lenders, at least those who service mortgages in their own portfolio, were first to adopt widespread mortgage modification programs and have much lower re-default

rates than the GSEs. (This is not to say that the industry responded quickly; only that the industry responded more quickly than the GSEs). Consider data from the latest OCC Mortgage Metrics Report.¹² In 2008 and 2009, the re-default rate on mortgage modifications by the GSEs was almost 50 percent higher than mortgage modifications pursued by lenders on their own mortgages. In 2008, for example, the 12-month re-default rate was about 58 percent for GSE modifications versus 40 percent for private lender modifications on their own portfolio loans. In 2009, the GSEs performed even worse on a percentage basis for the same measure (42 percent versus 25 percent for portfolio loans). By 2010, the GSEs 12 month re-default rate had caught up to that of portfolio loans. But in 2011, re-default rates for GSE modification are once again much higher than modifications of portfolio loans.

In looking at the recent data, one striking feature stands out. Many portfolio lenders, as well as private servicers, have turned to principal reductions to better manage defaults. Understanding what private investors and lenders do with their own loans is very instructive because it helps set a benchmark for behavior that is unaffected by the many conflicts of interest in securitization.¹³ According to the OCC data, portfolio lenders pursue principal reductions for more than 18 percent of mortgage modifications on their own portfolios. The FHFA still refuses to allow any principal reductions based on its calculations that more progressive modification and principal reduction programs will cost taxpayers money.

In addition to the fact that private lenders often pursue principal write-downs with their own funds at risk, other studies also support the value of principal write downs that reduce LTVs as a tool for modifying mortgages. A 2009 study by the Federal Reserve Bank of New York concluded “The data indicate that the re-default rate declines with the magnitude of the reduction in the monthly payment, but also that the re-default rate declines relatively more when the payment reduction is achieved through principal

¹² <http://www.occ.gov/publications/publications-by-type/other-publications-reports/mortgage-metrics-2011/mortgage-metrics-q3-2011.pdf>

¹³ See, for example, Tomasz Piskorski, Amit Seru, and Vikrant Vig. 2010. “Securitization and distressed loan renegotiation: Evidence from the subprime mortgage crisis”, *Journal of Financial Economics* 97, 369-397.

forgiveness as opposed to lower interest rates.¹⁴ As well, a recent study by Laurie Goodman supports the same conclusion, noting “Controlling for payment relief, we find that principal reduction modifications are more effective than either rate modifications or capitalization modifications. These differences by modification type are larger for modifications on prime/Alt A/option ARM loans than for subprime loans.”¹⁵

Another problem with all of these studies, and an issue that does not appear to be explicitly modeled by the FHFA analysis, is the risk of moral hazard. Private portfolio lenders are certainly be aware of this risk and have developed ways of minimizing moral hazard. Nonetheless, government backed lenders like the GSEs may face a higher risk of moral hazard than private lenders would. This would be a place, once again, where the GSEs might benefit from examining the practices of private portfolio lenders.

For some GSE mortgages, the existence of mortgage insurance (MI) appears to be a barrier to principal write-downs. However, the value of such MI is likely dubious. The GSEs have as much as \$150 billion of insurance from various MI companies, but more than 80 percent of those potential claims are underwritten by MI companies that are either insolvent or have a credit rating of BB- or worse. The suspect nature of these receivables gives the GSEs incentives to delay loss resolutions as much as possible and may impact the extent to which the GSEs efficiently manage losses and foreclosures.

Why Not More Private Capital and Expertise for the GSEs?

Another concern about the current process of how the GSEs have managed the housing crisis has been the lack of steps to bring in private capital and expertise in their businesses. It is important to note that the existing mandates for conservatorship do not require or even suggest that the GSEs bring private capital into their businesses. Of course there is a mandate to reduce risk, but that could be done without sharing the risks with private firms.

Nonetheless, the GSEs have not taken advantage of places where private capital and expertise might be valuable in reducing losses or helping to stabilize housing markets. For

¹⁴ http://www.newyorkfed.org/research/staff_reports/sr417.pdf

¹⁵ Amherst Mortgage Insight, 12/01/2011.

example, the fact that private portfolio lenders appear to have much lower re-default rates on mortgage modifications of non-performing loans (NPLs) suggest that the GSEs might profitably sell NPLs to specialized servicers. Private portfolio lenders sell certain NPLs to such specialized servicers. One might have expected the GSEs to do the same.

It is critically important to examine new ideas to help attract private capital and ideas to address the housing crisis. In my testimony before the Senate Subcommittee on Housing, Transportation, and Community Development of this committee I detailed a number of such proposals, including how to sell non performing mortgages and why sales of REO to long-term businesses dedicated to building a business in renting single family homes.¹⁶ I also discussed the potential for shared appreciation mortgages to help resolve the current glut of seriously delinquent mortgages.

Conclusion

I believe that the largest failure of conservatorship has been the unwillingness of the FHFA to adequately address the conflicts of interest it inherited when it took over management of the GSEs.

Consider the problem of how the GSEs would have managed a portfolio of MBS with above-market interest rates—securities that might sell at a price above the par value of the securities. For example, a pool of MBS with a 6 percent coupon might sell for \$1.10 for each \$1 of principal with such a high coupon. Given that the GSEs had more information than buyers about their own intentions with regard to refinancing, as well as greater information about the underlying mortgages and their expected performance, buyers might be quite wary of purchasing MBS at market prices from the GSEs. Buyers could be concerned about the potential that the GSEs might then turn around and take action that would result in widespread refinancing. Buyers might also be worried that mortgages inside the MBS were at imminent risk of default. In either case, the securities would pay off at par (\$1.00), leaving the buyer with an appreciable loss (\$0.10). Aware of the conflict of

¹⁶ Chris Mayer serves as an advisor to Pathway, a start-up firm in the business of purchasing houses for long-term rental.

interest, buyers might appropriately diminish their bids for agency MBS sold by the GSEs above par.

Under conservatorship, the FHFA could have appointed an independent trustee to manage the sale of the MBS over time, with the explicit mandate to maximize the returns for taxpayers. If the trustee were truly independent, this plan would have mitigated the conflict of interest and maximized the sale proceeds from the pool of MBS. Put differently, taxpayers likely would have received higher proceeds from the sale of MBS had the GSEs turned over management of their portfolio to an independent, third party because buyers would have paid more for the MBS absent a potential conflict of interest.¹⁷

Of course, the GSEs might have instead tried to earn even higher profits by keeping their portfolio and imposing frictions on refinancing. Even if imposing mortgage market frictions were to have maximized short-run profits on their portfolio, effectively conserving and preserving assets, it would have had other consequences in making a less efficient, less competitive, and more illiquid mortgage market and working against the public interest.

Nonetheless, such a policy would have ignored another option— widespread mortgage refinancing—that can and should have been a profitable business. My own analysis, conducted with Alan Boyce, Glenn Hubbard, and James Witkin, shows that refinancing should be profitable for the GSEs. By charging a slightly higher guarantee fee and creating a small fund to cover any possible losses from reps and warranties relief, refinancing could have been a way to help recapitalize the GSEs and help minimize taxpayer losses. Combining mortgage refinancing with an independent trustee would result in a win-win for taxpayers, mortgage borrowers, homeowners, and the larger economy.

¹⁷ Some might argue that it is necessary to have an investment portfolio to ensure the solvency of the guarantee business. However, since the GSEs are insolvent, the US Treasury already serves the role of liquidity provider under conservatorship. As the GSEs return to solvency, they may want to acquire assets that help meet capital and liquidity needs. However, there is no reason for the GSEs to make such investments in their own MBS, which only amplifies the GSEs exposure to various mortgage market risks. The trustee would use the proceeds from the sale of the assets of the GSEs (MBS) to pay down the GSE's liabilities.

It is not too late to achieve that win-win scenario. The FHFA still has the authority to follow such a prescription. However, current policies do not make such a policy shift appear likely.

Instead, Congress should consider changing the mandate of conservatorship to address its flaws. Legislation should mandate that an independent trustee be appointed to wind down the GSE's retained portfolio of MBS. The GSEs could continue to retain non-performing loans that they have bought back from securitizations as is necessary to perform their mortgage guarantee business. Independent management of the retained portfolio will make the eventual privatization or replacement of the GSEs considerably easier. Legislation should also mandate other steps to move towards attracting private capital into the mortgage market, including ideas such as trial programs for the sale of NPLs to third party servicers, the sale of REO to private investors, and provisions that allow the GSEs to provide responsible amounts of leverage for owners of single-family home portfolios in the rental business on a temporary basis.¹⁸ Legislation should also ensure that the GSEs remove all of the obstacles limiting access to mortgage credit as identified in the Federal Reserve White Paper. All borrowers should have access to refinancing without restrictions or qualifications other than being current on their mortgage and any refinancing programs should be available to be offered by any qualified originator to any qualified borrower.

Until we fix the housing market, it will be hard for the economy to fully recover. In this testimony, I have addressed a number of reasons that the lack of GSE reform continues to hold back the housing market and the economic recovery. I believe that immediate action is necessary to address fundamental flaws in the structure of the GSEs. Conservatorship as it now stands is laden with conflicts of interest between lending and portfolio management and holds back the re-introduction of private capital. These steps can occur now, even without a consensus on what the future of the US housing finance system will look like.

¹⁸ Any loans made available on portfolios of single-family homes might have a sunset provision so that lending is reduced over time as the private lending market recovers.

I appreciate the opportunity to address you today and look forward to answering any questions that you might have.

Figure 1: Mortgage originations according to the Mortgage Bankers Association

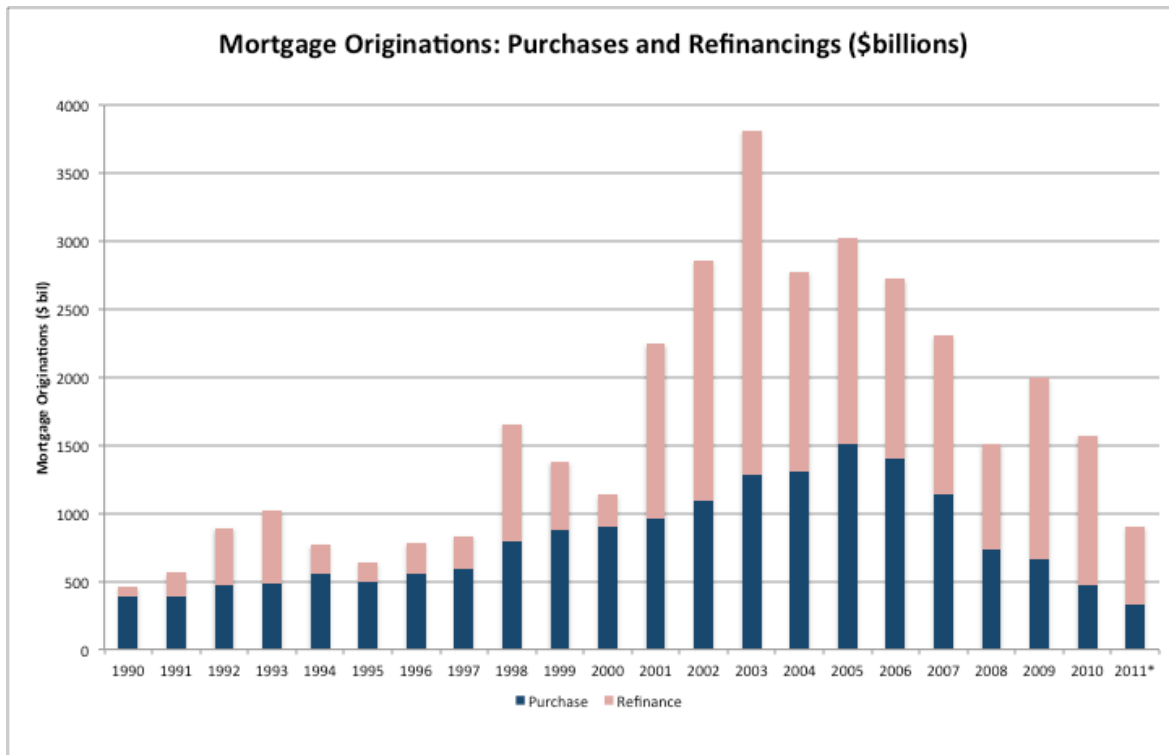


Figure 2: Mortgage refinancings according to the Mortgage Bankers Association

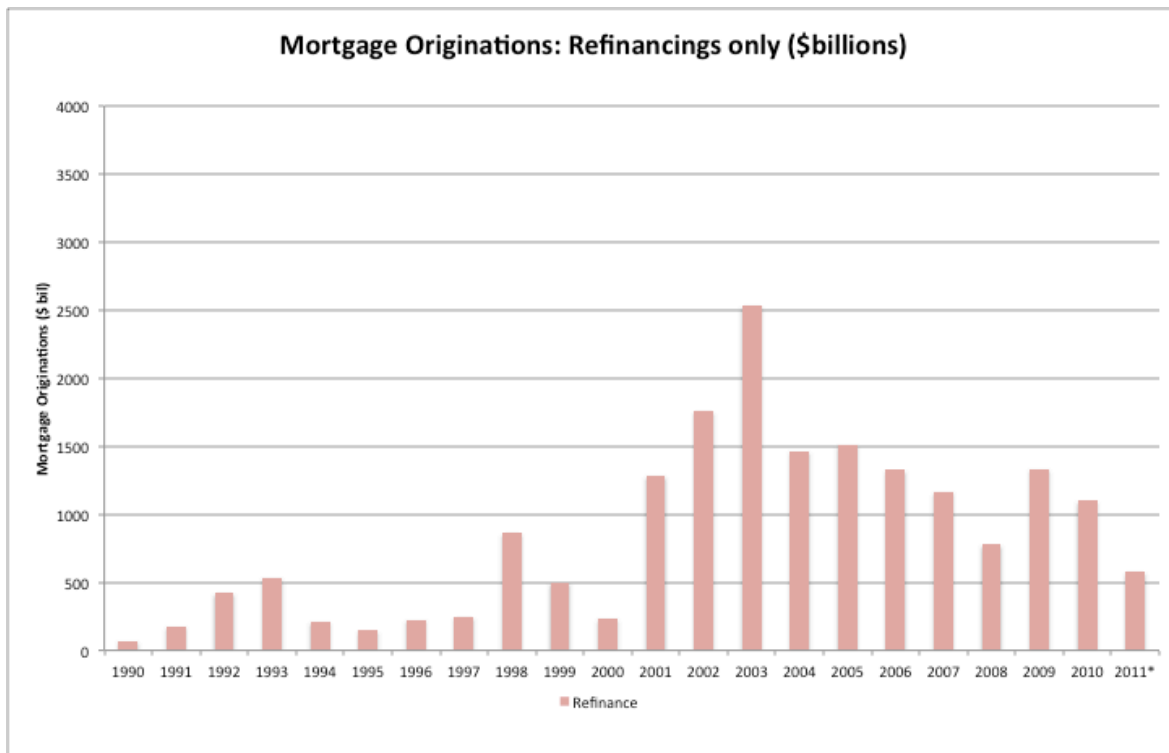


Figure 3: Spreads between Primary and Secondary mortgage markets, Bloomberg



According to this figure, spreads between retail and wholesale mortgage rates averaged about 25 basis points between 2000 and 2008, but have ballooned to 100 basis points or more after conservatorship.