
Statement before the Senate Banking, Housing & Urban Affairs Committee
On Housing Finance Reform: Should There be a Government Guarantee?

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This testimony is in three parts. First, I address a government guarantee for housing finance in the context of its adverse effects on the U.S. debt picture, on U.S. taxpayers, and on the overall health of the U.S. economy. In the second section, I address the arguments that are generally made in support of a government-backed system and show that they are without merit. In the third section, I briefly discuss how a fully private system for housing finance should be structured.

## I. Problems Associated with a Government Guarantee of the Housing Finance Market

### Effect on U.S. Debt

Although the government's overall debt position is not an issue that is usually part of the debate on housing finance policy, the fiscal position of the United States has deteriorated so seriously in recent years that the question whether to increase the national debt in order to support the U.S. housing market has now become highly germane.

The CBO recently estimated—even after the recent debt extension agreement—that if current policies are pursued the national debt will balloon from $14.3 trillion today to $23 trillion in 2021. Virtually all proposals for U.S. government assistance to the housing finance market assume that it will involve an explicit government guarantee, but even if this guarantee is only implicit—as it was with the government sponsored enterprises (GSEs) Fannie Mae and Freddie Mac—it will make no significant difference except in the budget numbers. As my AEI colleague Alex Pollock has pointed out,[1] the off-budget debt of the various government agencies—primarily Fannie Mae and Freddie Mac—currently totals $7.5 trillion, but the bailout of Fannie and Freddie proved beyond question that this debt is every bit a part of the nation's debt as the securities are issued by the Treasury.

So, without any change in policies and without any further increase in the GSEs' debt, the national debt will reach $30 trillion in ten years. With this background, it is hard to believe that there is actually a viable campaign to have the government support the housing market once

[1] Alex J. Pollock, The Government's Four-Decade Financial Experiment, The American.com, July 13, 2011, http://www.american.com/archive/2011/july/the-government2019s-four-decade-financial-experiment

again. At a time when Congress is having great difficulty trying to reduce the debt by finding places where spending can be cut, it is astonishing that some in the private sector can appear before Congress to ask for yet more debt in support of the housing market, a sector of the economy that could function perfectly well without *any* government backing.

Accordingly, in considering whether the government should back housing finance, the first consideration this committee should have in mind is whether it would be good policy at this time to add to the U.S. government's financial obligations.

**Effect on the Taxpayers**

There is no doubt that this campaign for government backing, if successful, will benefit certain groups—primarily the ones who are doing the campaigning. However, there is one group—U.S. taxpayers—who never seem to get a second thought when these campaigns are run. Nevertheless, it is the taxpayers who inevitably have to bear the burden of the subsidies that the government hands out through its support for housing finance.

The history here is consistent; the taxpayers are always left holding the bag. There's an explanation for this: the government is never fully compensated for its risks. In the 1930s, for example, Congress set up the federal savings and loan system (S&Ls), insuring their deposits—and giving them advantages over banks in attracting funds—so that they could finance mortgages at low rates. In adopting this program, the government took substantial risks for the taxpayers' account. S&Ls were expected to borrow money through short-term deposits but make long-term mortgage loans, an obvious prescription for disaster that only worked as long as interest rates were controlled by the government. When the capital markets were freed of controls, so that funds could flow where they were most useful, the government could no longer maintain controls on interest rates, and the higher rates they had to pay for funds drove many S&Ls into insolvency. The government could have been compensated for the risk it was taking on the S&Ls by raising the premium for their deposit insurance. But this would have raised the cost of their mortgage loans, defeating the purpose of the S&Ls. So when the consequences of the government's risks unfolded in the 1980s the taxpayers had to pick up a $150 billion tab.

Parenthetically, it should be noted that even the interest rate controls that made the S&L system work were another way of assessing the taxpayers. The deposit rate ceilings limited what depositors could earn on their savings, and penalized them even more directly when inflation caused prices and market interest rates to rise in the 1970s.

Now the taxpayers are being assessed to bail out Fannie and Freddie. These two government sponsored enterprises (GSEs) became insolvent because Congress materially increased their risks in 1992 by requiring them to acquire what were called affordable housing loans. These loans were to be made to borrowers at or below the median income in the places where they lived. Initially, 30% of the mortgages Fannie and Freddie were required to buy had to meet the affordable housing goals. However, the Department of Housing and Urban Development was given authority to administer the program, and by 2007 it had increased the goals so that 55% of all mortgages the GSEs bought had to be affordable housing loans. HUD also added subgoals that required the purchase of mortgages made to borrowers who were 80% and in some cases 60% of the median income in their communities.

It is of course possible to find prime mortgages among borrowers who are at or below the median income where they live—and maybe even borrowers who are at 80% or 60% of the median income—but not when more than half of the GSEs' loans had to be made to borrowers who frequently had blemished credit, lacked funds for downpayments and did not have the steady incomes necessary to maintain home ownership. Accordingly, in order to meet the affordable housing goals, Fannie and Freddie had to take significant risks on mortgage quality, and those risks—which turned into losses when the housing bubble deflated—eventually caused their insolvency. Here is a quote from Fannie Mae's 2006 10-K that makes exactly this point:

> [W]e have made, and continue to make, significant adjustments to our mortgage loan sourcing and purchase strategies in an effort to meet HUD's increased housing goals and new subgoals. These strategies include entering into some purchase and securitization transactions with *lower expected economic returns than our typical transactions*. We have also relaxed some of our underwriting criteria to obtain goals-qualifying mortgage loans and increased our investments in higher-risk mortgage loan products that are more likely to serve the borrowers targeted by HUD's goals and subgoals, *which could increase our credit losses.* [emphasis supplied]

The GSEs' regulator, the Federal Housing Finance Agency (FHFA) estimated several months ago that the losses these two firms will eventually suffer will range from $221 billion to $363 billion, but the continued deterioration of the mortgage market since that estimate was made suggests that the taxpayers will eventually have to pay more than $400 billion to make up the GSEs' losses.

Again, the government could have been compensated for the risks it was creating for Fannie and Freddie. It was well-known that they were regarded in the capital markets as government-backed, and for that reason were the beneficiaries of low borrowing costs. Accordingly, there were many proposals that the government charge Fannie and Freddie a guarantee fee, so in the event of their failure the government could have been compensated for the costs it would have to bear. But as in the case of the S&Ls these proposals to compensate the government and protect the taxpayers were strongly opposed in Congress (and by the GSEs themselves) because they would increase the cost of mortgages. So in a very direct way the taxpayers are now paying for the risks that the government required Fannie and Freddie to take. The administration itself recognizes this problem. As it noted in its February 11 statement on housing finance policy, "Political pressure to lower the price of government support increases the odds that the government will misprice risk and put taxpayers at risk."[2]

The government also imposes costs on the taxpayers because of its lack of discipline in maintaining the necessary reserves for insurance funds that are intended to pay for contingent losses when they occur. Government loves to describe its policies as insurance—insurance sounds so stable and sensible—but it doesn't do the one thing that private insurers do to cover their risks: it does not maintain adequate contingency funds. As the government's funds accumulate, the argument is made that times are different, that the fund is large enough, or even that the industry paying the premium is strapped for cash or investment capital. These pressures cause the government to let it ride, to refrain from collecting the necessary fees or premiums.

[2] Departments of Treasury and HUD, *Reforming America's Housing Finance Market*, 26.

This has occurred with the National Flood Insurance Program,[3] the Pension Benefit Guaranty Corporation,[4] the FHA,[5] and the Federal Deposit Insurance Corporation (FDIC).

Recent FDIC experience is fully consistent with Congress's reluctance to collect the necessary premiums in any insurance program. When the deposit-insurance system was reformed in 1991 in response to the failure of the FSLIC, Congress placed a limit on the size of the fund that the FDIC could accumulate to meet the demands of a future crisis. Since 1996, the FDIC has been prohibited by law from charging premiums to well-capitalized and stable institutions. As a result, between 1996 and 2006, institutions representing 98 percent of deposits paid no deposit-insurance premiums. In 2009, FDIC chair Sheila Bair observed: "An important lesson going forward is we need to be building up these funds in good times so you can draw down upon them in bad times."[6] Instead, once the bad times hit, the FDIC became insolvent and was forced to raise its premiums at the worst possible moment, thereby reinforcing the impact of the down cycle.

Finally, it should be noted that to the extent that government guaranteed mortgage-backed securities (MBS) are available they compete with Treasury securities. Many investors prefer them to treasuries because they represent virtually the same risk but offer a higher yield. Under these circumstances, the Treasury must pay a higher rate of interest than it would otherwise have to pay if there were no competition in the market. A recent Fed paper suggested that by purchasing GSE MBS (and thus taking those securities out of competition with the Treasury 10 year note) the Fed had reduced the interest rate on the 10 year note by as much as 30 to 100 basis points.[7] If correct, this is an enormous amount and in effect another cost of a government housing finance guarantee that will have to be paid by the taxpayers.

**Effect on the Economy as Whole**

Bubbles are a familiar phenomenon in any economy. They occur in the prices of many commodities from time to time, and even occur in the stock market, but they are particularly pervasive and long-lived in housing. In the last 30 years, there were housing price bubbles in

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[3] "FEMA Administrator Craig Fugate says the debt results partly from Congress restraining insurance rates to encourage the purchase of coverage, which is required for property owners with a federally backed mortgage. . . . 'It is not run as a business,' Fugate said. Congress' Government Accountability Office said in April that the program is 'by design, not actuarially sound' because it has no cash reserves to pay for catastrophes such as Katrina and sets rates that 'do not reflect actual flood risk.' Raising insurance rates or limiting coverage is hard. 'The board of directors of this program is Congress,' Fugate said. 'They are very responsive to individuals who are being adversely affected.'" (Thomas Fink, "Huge Losses Put Federal Flood Insurance Plan in the Red," *USA Today*, August 26, 2010.)

[4] As of the end of FY2010, the Pension Benefit Guaranty Corporation (PBGC) reported a deficit of $23 billion. "In part, it is a result of the fact that the premiums PBGC charges are insufficient to pay for all the benefits that PBGC insures, and other factors." Pension Benefit Guaranty Corporation, "2010 PBGC Annual Report," www.pbgc.gov/about/ar2010.html (accessed January 14, 2011).

[5] Barclays Capital estimates that the FHA has drastically underpriced the risk of its guarantees and could face losses of up to $128 billion. Barclays, "US Housing Finance: No Silver Bullet," December 13, 2010.

[6] Center on Federal Financial Institutions, "Federal Deposit Insurance Corporation," August 10, 2005, www.coffi.org/pubs/Summaries/FDIC%20Summary.pdf (accessed January 14, 2011). See also Congressional Budget Office, "Modifying Federal Deposit Insurance," May 9, 2005, "Currently, 93 percent of FDIC-insured institutions, which hold 98 percent of insured deposits, pay nothing for deposit insurance."

[7] Joseph Gagnon, Matthew Raskin, Julie Remache, and Brian Sack, "Large-Scale Asset Purchases by the Federal Reserve: Did They Work?", *FRBNY Economic Policy Review*, May 2011, p. 41

1979 and 1989—each of which lasted about three or four years—and a gigantic 10 year bubble between 1997 and 2007. There is good reason to believe that these housing bubbles are the result of government involvement in housing finance.

Among the purposes of past government support for the housing market was to assure a steady flow of funds for housing. There is no particular reason why housing—as opposed to any other area of the economy—might require a steady flow of funds. Automobiles, food and other retailing, mining, high tech and corporate finance generally do not require steady flows of funds and have survived and prospered quite well.

However, one of the effects of government support for a steady flow of funds to housing is that it lowers the financing risks for the homebuilders and others in the business of producing housing. Lowered risks encourage more homebuilding activity, because it reduces the likelihood of loss in the event of a market downturn. This, in turn, encourages speculation and increases the likelihood that housing bubbles will develop. When these bubbles eventually deflate, the losses they create represent a misallocation of capital that could have been used more efficiently elsewhere. Occasionally, as in 2008, the losses that occur as a result of a bubble's collapse can cause a financial crisis.[8]

The government's role in housing finance also has a negative effect on competition and thus reduces innovation and raises costs. The fact that the government cannot or will not price for risk should be an important clue about the distorting effect its guarantee will have on competition. For the reasons outlined above, the government's charge for supporting the housing market will be lower than the actual risk would demand, so its backing operates as a subsidy.

This happened with Fannie and Freddie. Because they were seen as government-backed, they were beneficiaries of lower funding costs in the market, and this allowed them to drive all competition from the secondary mortgage market. As a result, until they were felled by the affordable housing requirements, the GSEs' profits were extraordinarily high and their efficiencies and innovations low. In addition, they were not subject to market discipline because lenders did not believe that as government-backed enterprises they represented any significant risk.

Thus were Fannie and Freddie enabled to take the risks required by the affordable housing requirements without any scrutiny by the private market. The real costs to society appeared later. The same thing will happen with any government program that backs housing finance with a guarantee of any kind, whether it covers the issuers of mortgage-backed securities (MBS) or only the MBS. In both cases, competition will be reduced and market discipline impaired.

Accordingly, apart from its adverse effects on the debt and the taxpayers, government support for housing finance also tends to increase speculation in homebuilding and related activities, causing housing bubbles, waste of capital resources and impairment of the benefits of competition. This reduces, rather than increases economic growth and employment.

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[8] See Peter J. Wallison, *Dissent from the Majority Report of the Financial Crisis Inquiry Commission*, January 2011, http://www.aei.org/docLib/Wallisondissent.pdf

## II. The Arguments Advanced in Support of Government Guarantees Have no Merit

Having shown that government guarantees for housing are affirmatively harmful for the country's fiscal position, for taxpayers and for the U.S. economy, I will now discuss the likely form that any such guarantees will take, and the various reasons that the proponents of government guarantees advance to support of their position. These, I will show, are without merit.

### The Likely Form of a Government Guarantee Program

The spectacular failure of Fannie and Freddie has caused many proponents of government guarantees in housing finance to revise the structure of their proposals. Instead of guaranteeing the issuers of MBS like Fannie and Freddie, the new more sophisticated idea—including Option 3 in the administration's February 11 policy statement—is to have the government's guarantee attach only to the MBS and not to the issuers. These plans would obligate the government to pick up losses only after the capital of an MBS issuer has been exhausted and would require the issuer to pay a fee to the government to cover the government's risks. This idea is presented as though it will prevent losses similar to those that resulted from the operations of Fannie and Freddie; the implicit suggestion is that if only the MBS are guaranteed the government's risks will be reduced and the likelihood of taxpayer losses will be minimized.

This is an illusion, for several reasons. First, as noted above, the government cannot effectively set a fee to cover the taxpayers' risks on the government's program. Even if government had the incentives and capabilities to assess a proper fee, the assessment would be seen and attacked as an unfair tax on housing or on the borrowers who would have to pay higher interest rates. For example, when the Office of Management and Budget suggested near the end of the Clinton administration that Fannie and Freddie pay a fee for the government's risk on its implicit backing of their obligations, the idea was immediately derided as a tax on homeownership, the administration was inundated with protests from the housing industry, and the proposal was promptly abandoned.

Apart from whether the appropriate fee can be credibly established, history shows that Congress does not have the political fortitude to impose a fee that burdens homeowners or the housing industry. In addition, it is fanciful to believe that the companies set up by the government to perform a government mission will not be viewed in the market as government-backed. It is necessary only to point out that the GSEs' charter says explicitly that they and their obligations are not guaranteed by the government, but when they became insolvent the administration immediately took them over and assured creditors that they would be fully paid.

Similarly, as discussed above, even if the government were to impose a fee of some kind, the political process would—as it has in the case of the FDIC and other "insurance" programs—soon stop the accumulation of a reserve fund to cover eventual losses. So when the losses actually occur, the taxpayers would be the ones to bear the costs.

Nor is the problem solved—as many of the supporters of these guarantee plans suggest—if the government is liable for losses on guaranteed MBS only after the issuer of the MBS has absorbed the first losses and exhausted its capital. It is true that in this case issuers will have an

incentive to be cautious about risk taking, but the government guarantee eliminates an important element of market discipline—the risk aversion of investors. The existence of a government guarantee will mean that no MBS buyer needs to be concerned about the quality of the underlying loans or the financial stability of the issuer. This is exactly analogous to the effect of deposit insurance on risk taking by banks. As is well known, deposit insurance permits bank depositors to ignore the risks a bank is taking—the principal reason that so many banks fail. As in the case of deposit insurance, government backing of MBS will eliminate investor concerns about both the financial stability of the issuer and the quality of the mortgages underlying the MBS. The effect of this moral hazard is certainly one of the lessons of the GSEs' failure.

The GSE experience also shows how difficult it will be to limit the scope of any government support program. The GSEs were seen as providing advantages to the middle class, mostly in the form of lower mortgage costs, and it was a natural impulse for Congress to want to extend those benefits to other constituents. The affordable housing goals were one example of such an extension, but so were the higher conforming loan limits, adopted in 2008, which allowed Fannie and Freddie to extend the benefits of their government-backed low-cost financing to borrowers who were not at all low income or in any way economically disadvantaged. This is the way a legislature will work in a democracy, and there is no reason to assume that any limitations Congress might put on government support of the mortgage market will continue for very long. Government-conferred benefits provide subsidies to certain favored groups, and Congress will always be attentive to extending these subsidies to others.

Where moral hazard is present, regulation is imposed to protect the government and the taxpayers, and regulation of the issuers of the guaranteed MBS is another prescription of the advocates of government guarantees. They argue that regulation will ensure that the issuers have sufficient capital to cover the risks they will be taking and thus to protect the government and the taxpayers from loss. But experience with bank regulation has shown that regulation does not prevent excessive risk taking and does not ensure sufficient capital to cover risks. Its effect, indeed, is almost the opposite. By increasing moral hazard, it encourages risk-taking. Moreover, as shown by the recent experience of the FDIC, which (despite prompt corrective action) has suffered losses in the great majority of banks it has closed in the last three years, regulators are frequently unable to determine the financial condition of a regulated entity until it is too late. In these cases, the taxpayers will once again end up taking the losses.

Accordingly, the structure of most proposals for government housing market guarantees will not provide any protection for the taxpayers. As with Fannie and Freddie and the S&Ls, when the losses come in the taxpayers will eventually have to pay the bill.

Nevertheless, the proponents of government guarantees and their congressional supporters argue that there cannot be a functioning housing finance market without government guarantees, and in the discussion below I show that these arguments have no merit.

**Institutional Investors**

One of the most frequently heard arguments in favor of government guarantees is that institutional investors will only buy US mortgages, or MBS based US mortgages, if they are backed by the government. On its face, this seems absurd, since in most advanced economies the housing finance market operates effectively without government guarantees. Of course, if it were

true that institutional investors will not buy MBS without a government guarantee, it would be a weighty argument. However, it's a myth, disproved by the data, which shows that institutional investors are not major buyers of GSE securities.

According to the Federal Reserve's flow of funds data, nonbank institutional investors had assets of $28 trillion in the fourth quarter of 2010. About $13 trillion of this amount was invested in fixed-income or debt securities—but only $1.8 trillion was invested in U.S. government-backed securities issued by government agencies or by Fannie and Freddie. Thus, even at a time when private housing finance has not yet revived—and most of the investment in housing is flowing through Fannie and Freddie or the Federal Housing Administration (FHA)—less than one-seventh of the funds invested in debt securities by institutional investors were invested in government-backed GSE mortgage securities.

Most likely, even these investments are only for liquidity purposes—made by money managers who want some small amount of government securities that can be sold at any time in order to raise cash, no matter what the conditions in the market. These investors hold GSE securities because their yield is slightly higher than treasuries of equivalent maturity. As discussed above, it should be noted that by providing these investors with a security that carries a government guarantee—an alternative to a Treasury security—Congress is raising the Treasury's interest costs, another cost levied on the taxpayers.

By contrast, at the end of 2010, nonbank institutional investors had assets consisting of $2.6 trillion in both residential and commercial whole mortgages. Whole mortgages are not guaranteed by Fannie and Freddie or the FHA. This means that even after the financial crisis, institutional investors held a larger dollar amount of mortgages that are *not* backed by the government than the mortgages that are perceived as government-guaranteed.

The Fed's flow of funds data also includes a $4.6 trillion category called "corporate and foreign bonds," which includes privately issued mortgage-backed securities. Although this category is not further broken down, the mortgage-backed securities within it would add to the total of mortgage assets not guaranteed by the government.

This data should have a profound effect on the question of whether to replace Fannie and Freddie with another government-backed system. They show that nonbank institutional investors are not investors in government guaranteed debt (except for liquidity purposes) and prefer private mortgages and mortgage-backed securities to government-backed instruments.

Who are these institutional investors, and why do they prefer whole mortgages and private mortgage-backed securities over U.S. government-backed mortgage securities? The biggest members of this class fall into three categories—life insurers ($5.1 trillion in assets), private pension funds ($6 trillion) and mutual funds ($8 trillion). What these institutional investors have in common is a desire for yield. Life insurers and pension funds have long-term liabilities they have to cover, and mutual funds function in a competitive environment in which yield is important to retaining their investors. Privately issued instruments provide market rates of return that allow these institutions to meet their long-term obligations. U.S. government agencies, by contrast, don't pass this test. Their yields are low because their interest rates, subsidized by the taxpayers, are lower.

That doesn't mean they have figured out how to escape from market risk. Instead, as we know from experience, the taxpayers eventually have to compensate for this risk through bailouts of Fannie and Freddie and other government housing finance ventures. This analysis is confirmed by looking at who the buyers of government-backed securities actually are. In 2006, before the financial crisis, 11% of the holders were foreign central banks, 23% were federal, state and local governments and enterprises and their pension funds, and 21% were insured depository institutions. Thus more than 50% of the demand for Fannie and Freddie mortgage-backed securities came from U.S. and foreign governments, or from organizations the government controls or regulates. In other words, government-backed mortgage securities are primarily attractive to risk-averse institutions or those with regulated capital requirements.

Thus, if we want U.S. and foreign institutional investors to invest in our mortgage market, we should be looking to a private system of mortgage finance, and not one run or backed by the government. Private U.S. institutional investors have $13 trillion invested in fixed income or other debt securities. Much of this investment is going into corporate debt, including junk bonds, because mortgages or mortgage-backed securities yielding market rates are not available—and were not available even in 2006. If there were good private mortgage-backed securities available, institutional investors would be eagerly investing in the U.S. housing market.

**Increase in Mortgage Rates.**

Another argument in favor of a government-backed system is that the interest rates on mortgages will be lower than in a private system. There is little question that a government backed housing finance system can deliver mortgages at lower rates than private systems, but that's because the government is taking risks for which it will not be compensated. Instead, when the government's losses show up, the taxpayers are handed the bill. If the taxpayers were not the ultimate insurer of the government's risks, the rate on government-backed mortgages would be the same as private mortgages, because the government-backed loans would then reflect all the risks inherent in the structure. Those who support a government-backed system must concede that it only provides lower rates because it puts the taxpayers at risk.

**The 30-year Fixed Rate Mortgage.**

Many proponents of government guarantees in housing finance argue that without a government role in the housing market the 30-year fixed-rate mortgage will not be available to American homebuyers. On its face, this is not true, since anyone can go to the Internet and find lenders offering *jumbo* fixed-rate thirty-year loans—which, by definition, have no government backing. It is true that, at this point, a 30-year fixed-rate mortgage is somewhat more expensive than a government-backed 30-year fixed-rate mortgage, but the lower cost of the government mortgage simply means that the taxpayers are providing a subsidy to the person who wants a government-backed mortgage with these terms.

Anyway, history has shown—and simple economics would anticipate—that a government subsidy for a 30-year fixed-rate mortgage is not good policy. The subsidy causes most borrowers to choose the 30-year loan, since in general it offers a fixed, low monthly payment with a government-subsidized "free" prepayment option. Supporters, including the administration in its Option 3, point to the apparent stability it provides to borrowers. This

"stability," however, carries with it several serious deficiencies. A 30-year loan amortizes slowly, keeping the homeowner's equity low and debt level high for a good portion of the loan period. In other words, it increases the homeowner's leverage. If the home is sold after seven years (the average duration of occupancy), the homeowner has not accumulated much equity.[9] In addition, the "free" prepayment option encourages equity withdrawal through serial refinancing.

For these reasons, it is peculiar that the proponents of government backing are never asked to explain why the taxpayers should be subsidizing a 30-year fixed-rate mortgage. This is not to say that this mortgage should not be available, but only that homeowners who want such a loan should not expect the taxpayers to subsidize its availability. In today's market, it is available at a slightly higher cost without a taxpayer subsidy.

**The TBA market**

Another frequently heard argument from the supporters of government backing for residential mortgage finance is that only with government backing can the To-be-Announced (TBA) market exist. This is another myth. First, however, it is important to put the TBA issue in perspective. Just as commodity futures markets enable farmers to hedge the price risk of their commodities, the agency TBA forward market allows mortgage originators to mitigate their interest rate risk. Today, originators of both agency and non-agency mortgages use the agency market to hedge the risk of a change in interest rates between the time that a mortgage rate is "locked in" and the time the mortgage is actually closed and securitized. Reducing that risk has a positive effect on mortgage rates, but it is only one of the elements that go into the full cost of a mortgage. It would be dwarfed, for example, by a ¼ point increase in overall interest rates. The mortgage market could function effectively without a TBA market, but total mortgage costs—the principal component of which is the interest rate—would be slightly higher. Nevertheless, government backing is not a requirement for the TBA market, just as it is not a requirement for a 30-year fixed rate mortgage.

It is perfectly possible for a TBA market to develop for private MBS. This is because the TBA market function does not exist because of a government guarantee but because of a high level of liquidity in the market—a large number of MBS that are regularly bought and sold. That liquidity is created by a convention—an agreement—among market participants about what they will accept as sufficient information about a particular pool of MBS. That convention, embodied in the *Uniform Practices for the Clearance and Settlement of Mortgage-Backed Securities* – administered by the Securities Industry Financial Markets Association (SIFMA) and otherwise known as the "Good Delivery Guidelines"—establishes that a seller and buyer in the TBA market need only agree on six factors to confirm a trade: issuer, maturity, coupon, price, par amount, and settlement date.[10] For example, as described in a recent paper by the Federal reserve Bank of New York, "a TBA contract agreed in July will be settled in August, for a security issued by Freddie Mac with a 30-year maturity, a 6% annual coupon, and a par amount of $200 million at a price of $102 per $100 of par amount, for a total price of $204 million."[11]

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[9] See, for example, Peter J. Wallison, "What's So Special about the 30-Year Mortgage?" *Wall Street Journal*, February 1, 2011, www.aei.org/article/103092.

[10] James Vickrey and Joshua Wright, "TBA Trading and Liquidity in the agency MBS Market," *Federal Reserve Bank of New York Staff Reports*, Staff report no. 468, August 2010, p.7

[11] Ibid.

The limitation on the information available to the buyer makes the agency MBS, in effect, "fungible" with other agency MBS already outstanding and thus adds significantly to the liquidity in the market. As also explained in the Federal Reserve paper: "Paradoxically, the limits on information disclosure inherent in the TBA market actually *increase* this market's liquidity, by creating fungibility across securities, and reducing information acquisition costs for buyers of [agency] MBS."[12]

The existence of GSEs makes it easier for a TBA market to exist, because it removes credit risk as one of the risks that market participants must consider, but that is not essential for the TBA market to function. If the mortgages on which MBS are based are all relatively similar in quality—as they would be if certain minimum standards existed—that, combined with mortgage insurance, would create a private sector product not far off from an agency MBS. Then, all that would be necessary for a private TBA market would be a large number of MBS issuances and agreement on the same terms—issuer, maturity, coupon, price, par amount, and settlement date—as the current convention outlines for the agency TBA market.

**Access to Capital in a Crisis.**

Finally, supporters of a government-backed system argue that the government's involvement will keep the market functioning in the event of another financial crisis. The administration's February 11 report expresses concern about whether—in a fully private market—there will be sufficient access to mortgage credit during a crisis. The administration notes, "absent sufficient government support to mitigate a credit crisis, there would be greater risk of a more severe downturn, and thus the risk of greater cost to the taxpayer."[13] This idea gave rise to the administration's Option 2, which is a private market with a government backstop that would be invoked only in the event of a financial crisis that makes credit unavailable for housing.

However, if one assumes that some backstop is necessary, the Federal Reserve has already demonstrated that it can liquefy the housing market by purchasing MBS. The only question is whether the MBS are of good quality. If the underlying mortgages meet the quality tests outlined below, and include mortgage insurance, they would be of sufficient quality so that the Fed could purchase them without taking significant risks.

## III. How a Private Market would be Structured

This testimony is not the place to to describe in detail how a private MBS market would work. However, in March 2011, my AEI colleagues, Alex Pollock and Ed Pinto, and I issued a white paper[14] in which we responded to the administration's February 11 statement and showed how Option 1 in that administration report—which discussed a private market for MBS—would work. The white paper was based on four principles:

[12] Id., p12
[13] Departments of Treasury and HUD, *Reforming America's Housing Finance Market*, 28.
[14] Peter J. Wallison, Alex J. Pollock and Edward J. Pinto, *Taking the Government Out of the Housing Finance: Principles for Reforming the Housing Finance Market*, AEI, March 2011, http://www.aei.org/paper/100206

**I. The housing finance market—like other US industries and housing finance systems in most other developed countries—can and should principally function without any direct government financial support.**

Under this principle, we note that the huge losses associated with the savings and loan (S&L) debacle of the 1980s and Fannie and Freddie today did not come about *in spite of* government support for housing finance but *because of* that government backing. Government involvement not only creates moral hazard but also sets in motion political pressures for increasingly risky lending such as "affordable loans" to constituent groups.

Although many schemes for government guarantees of housing finance in various forms have been circulating in Washington since last year, they are not fundamentally different from the policies that caused the failures of the past. The fundamental flaw in all these ideas is the notion that the government can successfully establish an accurate risk-based price or other compensatory fee for its guarantees. Many examples show that this is beyond the capacity of government and is in any case politically infeasible. The problem is not solved by limiting the government's risks to MBS, as in some proposals. The government's guarantee eliminates an essential element of market discipline—the risk aversion of investors—so the outcome will be the same: underwriting standards will deteriorate, regulation of issuers will fail, and taxpayers will take losses once again.

**II. Ensuring mortgage quality, and fostering the accumulation of adequate capital behind housing risk, can create a robust housing investment market without a government guarantee.**

This principle is based on the fact that high-quality mortgages are good investments and have a long history of minimal losses. Instead of relying on a government guarantee to reassure investors in MBS, we should simply ensure that the mortgages originated and distributed are predominantly of prime quality. We know the characteristics of a prime mortgage, which are defined in the white paper. They do not have to be invented; they are well known from many decades of experience.

Experience has also shown that some regulation of credit quality can prevent the deterioration in underwriting standards, although in the last cycle regulation promoted lower credit standards. The natural human tendency to believe that good times will continue—and that "this time is different"—will continue to create price booms in housing, as in other assets. Housing bubbles in turn—by suppressing delinquencies and defaults—spawn subprime and other risky lending; investors see high yields and few defaults, while other market participants come to believe that housing prices will continue to rise, making good loans out of weak ones. Future bubbles and the losses suffered when they deflate can be minimized by interrupting this process—by focusing regulation on the maintenance of high credit quality.

**III. All programs for assisting low-income families to become homeowners should be on-budget and should limit risks to both homeowners and taxpayers.**

The third principle recognizes that there is an important place for social policies that assist low-income families to become homeowners, but these policies must balance the interest in low-income lending against the risks to the borrowers and the interests of the taxpayers. In the

past, “affordable housing” and similar policies have sought to produce certain outcomes—such as an increase in homeownership—which turned out to escalate the risks for both borrowers and taxpayers. The quality of the mortgages made in pursuance of social policies can be lower than prime quality—taxpayers may be willing to take risks to attain some social goods—but there must be quality and budgetary limits placed on riskier lending to keep taxpayer losses within known and reasonable bounds.

**IV. Fannie Mae and Freddie Mac should be eliminated as government-sponsored enterprises (GSEs) over time.**

Finally, Fannie and Freddie should be eliminated as GSEs and privatized—but gradually, so the private sector can take on more of the secondary market as the GSEs withdraw. The progressive withdrawal of the GSEs from the housing finance market should be accomplished in several ways, leading to the sunset of the GSE charters at the end of the transition. One way would be successive reductions in the GSEs’ conforming loan limits by 20 percent of the previous year’s limits each year. These reductions would apply to conforming loan limits for both regular and high-cost areas. This should be done according to a published schedule so the private sector can plan for the investment of the necessary capital and create the necessary operational capacity. The private mortgage market would include banks, S&Ls, insurance companies, pension funds, other portfolio lenders and investors, mortgage bankers, mortgage insurance (MI) companies, and private securitization. Congress should make sure that it facilitates opportunities for additional financing alternatives, such as covered bonds.

**How a Private Market will Attract Capital**

The most important question for purposes of this testimony is how a private market would attract capital. I have already discussed the size of the institutional investor market, and shown that these investors are not attracted by government-guaranteed MBS, except for liquidity purposes. Without any question, institutional investors will buy mortgages that have attractive risk-adjusted yields. However, if we want mortgage interest rates to remain low, we have to reduce the risks associated with these loans. In that case, institutional investors will not build in a large risk premium, which will add to mortgage costs.

One of the most effective ways to do this would be to specify certain minimum terms for all securitized mortgages. These would include a minimum down payment of 10 percent, a borrower’s FICO credit score of at least 660 and a borrower’s debt to income ratio in the upper 30s. Even when these minimum criteria are specified, however, institutional investors will want assurance about the overall quality of the mortgages in the pool. One way to accomplish this is to create a contractual structure in which the top tiers do not take losses on the pool until the lower tiers are wiped out. This is the structure used in many securitizations before the financial crisis and in the securitizations that take place today.

In these offerings, the risk is mitigated by creating subordinated tranches (or tiers) that take the first losses. Only if the losses are greater than the size of those subordinate tranches will the top tiers (normally rated AA or AAA) suffer losses. This is an effective system, and could be attractive to institutional investors, but it has two problems: first, if the quality of the mortgages in the pool is poor, the subordinate tranches have to be thick (to absorb more expected losses) and this will raise interest rates on the mortgages in the pool; second, institutional investors do

not have the facilities or capabilities to underwrite mortgage pools, and because of the failure of the rating agencies during the financial crisis institutional investors are now reluctant to rely on rating agencies for assurance about the quality of the mortgages in the pools. Therefore, another assurance mechanism is necessary.

The best and most efficient system for this is mortgage insurance. Under current state regulation of mortgage insurers, they are required to hold at least half of their revenues in a reserve fund for 10 years, an amount more than sufficient to deal with any foreseeable housing downturn. In addition, they have the facilities and ability to do the underwriting that institutional investors lack. It appears that if mortgage quality is controlled so that only prime mortgages are securitized, mortgage insurers can write insurance that covers losses down to a loan-to-value ratio of 60% without increases in mortgage costs that significantly exceed what Fannie and Freddie are now charging. A system that provides for a minimum set of mortgage standards, combined with mortgage insurance, could reduce the risk for institutional investor substantially. This would permit interest rates on the mortgages underlying the MBS to be competitive with any government backed system where the taxpayers are not compelled to subsidize the risk.

A complete copy of the white paper, and its plan for a private housing finance market, may be found at http://www.aei.org/paper/100206.

This concludes my testimony.